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Why property values did not decline with the Q3 2013 rise in interest rates

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From an historical perspective, capitalization rates carry a relationship to 10-year treasury bond rates. Premiums over 10 year treasuries vary but spreads of 200 basis points (BP's) to 350 BP's depending upon economic conditions are not unusual. After this summer's rise of 100+ BP's over the spring 2013 treasury rate of 1.62%Â±, one of the key questions asked of me was "What will be the impact on property value?"

Those that I talked with provided a variety of answers and most suggested that it was different this time around. This article is written following attendance at CBRE's "America's Summit" October 7-11, 2013 in Las Vegas. Part of the program was one-hour breakout sessions with various topics. One of the key sessions was titled "Following The Money - Global Capital Flows." There was a 5 person panel made up of CEO's, and COO's of REITS, public and private investment funds representing $500Â± billion (yes billion) in capital. This article will present the thinking of some of the best minds in the business.

The Traditional View

Three panelists presented the case that this time around, value changes were not being seen.

Investors had been hammered by the spin offs of the 2008 Great Recession. The actions of the Federal Reserve to keep rates artificially low dropped lending rates and built a prop under commercial and residential real estate values.

What ensued was a search for yield. This unlocked the huge supply of capital forces to the sidelines by the Great Recession. With capital chasing real estate not seen since 2007, the bidding process for quality real estate supported the market. With supply of capital exceeding demand, what should have been a value decline did not take place.

Another reason given was that spreads between 10-year treasuries and capitalization rates had widened, leaving a cushion for real estate investors. The thought presented was that an excess spread existed and that rates would have to move another 100 BP's before value changes would take place.

Contrary Opinions

The view put forth by two of the panel was that most transactions today are underwritten to an internal rate of return (IRR) of 6% to 7%. This was reported to be unrealistic because treasuries will rise. The central theme was "do not be bullish on US real estate"; as all as it will take is an upward movement in treasuries between now and 2015 for those buying prime real estate today to get caught.

The thought process put forth was that for real estate as a class, the risk/return tradeoffs make acquisitions problematic unless value-add characteristics are found within the rent roll. Further, vacancy is looked at as an opportunity as real estate markets in major metropolitan areas are in recovery.

What has happened is that the debt side of the equation has changed. Borrowers, to justify purchase, have moved their lock in interest rates from 10 year money down to 7 year and 5 year money in order to win "bids" that are part of the acquisition process. This move alone creates a level of risk in real estate which mirrors that of five years ago in the 2008-2009 timeframe. To proceed on a 5 to 7 year horizon unless an exit strategy is in place to sell during that time frame adds a level of pressure to the real estate investment process.

Conclusion

The Q&A part of the Global Capital Flows panel sparked lively commentary. That commentary reminded us that while values may have appeared to not decline, they really had.

From a long-term perspective, we were reminded that 100 BP's to 125 BP's changes in 10 year treasury rates typically changed capitalization rates by 50 BP's. While indications were that value decline did not occur, under the surface actions suggested otherwise.

Direct capitalization rates typically are based on what is called "stabilized" net income. Under the definition of stabilized income in the Dictionary of Real Estate Appraisal, there are key words:

"Any transitory conditions cease to exist and the existing conditions are those expected to continue over the
economic life of the property."

Conditions which currently exist are certainly not transitory. We do not know how long these conditions will continue.

Real estate at one time was bought as a long term investment. With changes that have occurred over the last 10 years, ebb and flow of values suggest far more factors to be considered.

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