Should commercial real estate fear rising interest rates? - by Bill Pastuszek

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Maybe housing is in a bubble. Some think so. The Dallas Fed was blunt in its assessment: “U.S. house prices are again becoming unhinged from fundamentals.” But their researchers don’t think it would be a repeat of the Great Recession/Housing Crash of 2008. The article goes on to say: “For starters, homeowners are in much better shape now than they were heading into the 2008 meltdown.”

Do you think, like many, secretly and not so secretly, believe that cap rates are “crazy low,” and, thus, unsustainable, and, that we are headed for a “correction?”

A publisher of a highly credible investor survey tells us: “In the first quarter of 2022, the average overall capitalization (cap) rate decreased in more than half of markets surveyed. In all markets, the average decline was 4 basis points (!). However, year-to-year, the report goes on to say, “more dramatic differences are observed.” Current market averages are lower today than they were a year ago with 24 markets posting double-digit decreases.

Not surprisingly, the survey’s apartment and warehouse markets show some of the largest decreases in average overall cap rates over the recent past. Office markets are not quite as robust. For example, the Boston office market shows a reasonably stable overall cap rate from a year ago and a lower cap rate than five years ago.

Rates could drop even more as investors vie to possess CRE income streams, according to a recent analysis from a major financial corporation. The report suggests that cap rates may be reaching a cyclical bottom.

The report, notes that average cap rates across office, industrial, retail, multifamily, hotel, and senior housing have been dropping for a decade. Why rates are at a low today, the report notes, is “due to today’s low interest rate environment and the limited supply of commercial real estate properties relative to strong post-pandemic demand.” No blockbuster news here. The report goes to say that all indicators suggest that there is still room for rate compression (and further price growth) but there are factors that suggest this trend may be moderating or ending.

What happens now that rates are going up and are likely to go up more? How does a higher cost of money and inflation factor into real estate investing and income property valuation?

As regards “small cap commercial property trends, a recent article in MBA Newslink, the daily newsletter of the Mortgage Bankers Association, notes that small-cap CRE prices ‘Rationally Tracking’ fundamentals. According to Boxwood Means LLC, “Small-cap commercial real estate prices have accelerated at an unprecedented rate but are not overinflated.” The Boxwood National Small Commercial Price Index posted double-digit annual price growth. It is further noted that, since the short COVID recession in early 2020, price growth since then represents the highest two-year jump in prices.

Observers note that there is a long-term gap between small-cap commercial real estate supply and demand since the end of the Great Recession, a trend similar to housing. While demand increased, supply did not follow suit to respond to demand. This is another factor producing current “disequilibrium” in commercial markets.

What is the effect of rising interest rates on cap rates, broadly? Using a traditional weighted cost of capital technique – a “Band of Investment Technique” as it referred to in the appraisal profession – where the two major inputs are equity and debt rates, with debt being the largest percentage of the investment, it is mathematically logical for cap rates to increase when the cost of debt increases, holding equity returns equal. However, most data sources suggest that won’t be the case in the near future. So, therefore, investors may have to further adjust their equity position expectations downward if cap rates remain stable or compress more? How much can equity position adjust?

There may be more going on here. Clearly, debt has a role to play in investment activity. Unless one is dealing in an unleveraged environment, such as the case with institutional investors, cost of debt and its effect on cash flow is a real factor, considered both by lenders and investors.

Consider that historically, real estate has always been considered a strong inflation hedge. Why is this so? Real estate is a long horizon investment and investors look beyond short-term fluctuations. Also, real estate assets have inflation and rising interest rate defenses built into their very structure. Devices like expense pass throughs to tenants provide some protection from rising prices and many investments (lodging, self-storage, multi-family) can adjust rents quickly to counter rising expenses. In terms of financing, both lenders and borrowers have built into loans ways of coping with rising money costs. The world has learned much since the mega interest rates of the 1980’s.

But, at some point, the pain may become too real and would affect investor expectations. There are some historical precedents to consider. Back in the 1980’s, inflation got squeezed out very painfully – many thought for good - with rates at +-18%. At that level, real estate activity was severely hampered. What will it take to dampen current CRE enthusiasm? Let’s see what the next couple of quarters tell.

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