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PUBLICATIONS

AMERICAS

JUNE 1, 2018: VOL. 30, NUMBER 6

Going up: Interest rates are rising. What will that do to real estate in the foreseeable future?

BY MARD NAMAN

Among institutional investors, interest rate increases generate a lot of interest, but even more worry and concern. In fact, rising interest rates are overwhelmingly the main concern among commercial real estate executives, according to Seyfarth Shaw's most recent Real Estate Market Sentiment Survey. So investors were paying close attention when the Federal Open Market Committee, under new Federal Reserve Chairman Jerome Powell, announced a 25 basis point increase after its March 21 meeting. And the Fed stated its intention to increase rates at least two more times in 2018 and three times in 2019, up from its previous intention to raise rates only twice next year.

We are clearly in a rising interest-rate environment, and the Fed has indicated its willingness to keep raising rates even if inflation doesn't reach a 2 percent policy target. How much of this investor concern is justified? What might be the impact of rising rates on real estate valuations, cap rates and lending?

Interest rates and cap rates

CBRE, in its February *MarketFlash,* predicts rate increases will have no immediate impact on cap rates, and cap rates will stay flat or only elevate slightly this year. The analysts interviewed for this article share a similar view and pointed to several factors likely to support real estate valuations even in a rising interest-rate environment: the presently wide spreads between cap rates and U.S. Treasuries, strong real estate market fundamentals, and global inflows of capital to U.S. real estate.

"Modest increases in interest rates will have limited impact on private real estate cap rates and real estate pricing, and is not an immediate concern," says Lee Menifee, head of Americas investment research at PGIM Real Estate. Menifee cautions, however, there are clear downside risks to pricing if rates spike quickly.

"We agree that rising interest rates pose no immediate threat to property prices or cap rates," says Calvin Schnure, senior vice president, research and economic analysis, for Nareit. Cap rates are low, but their spread to yields on 10-year Treasury securities is wide, still within long-term averages and able to absorb the interest rate increases so far.

The impact of rising interest rates on cap rates will be modest in the near term, agrees Asieh Mansour, a senior adviser to The Townsend Group, a wholly owned, indirect subsidiary of Aon Plc. With three or even four rate hikes this year, interest rates are still low on a historical basis, she notes, and should not immediately disrupt cap rates. Because the spread between cap rates and 10-year Treasury yields remains healthy, modest increases in rates should not drive up cap rates on a one-for-one basis.

Chris Macke, managing director, research & strategy at American Realty Advisors, points out the Fed raised the federal funds rate 17 times between 2004 and 2006, from 1.00 percent to a cycle high of 5.25 percent. The 10-year Treasury during the same period, however, only increased 41 basis points, while cap rates dropped. "Raising short-term rates does not necessarily translate to higher cap rates," he says.

A recent AEW study found commercial real estate values actually rose in five of seven rising interest-rate periods over the past 35 years, according to Tom McNearney, chief investment officer at Transwestern. In a separate study by Prudential, during six periods of rising interest rates that corresponded with economic growth, real estate outperformed other assets in five of those six periods, adds McNearney. The only period when real estate underperformed was a period of oversupply. "Fortunately, we have been reasonably restrained on new supply, so economic growth should translate into enhanced value for commercial real estate," he concludes.

As the economy improves, this should feed into higher operating income and a lower risk premium, both of which may offset any impact from rising Treasury yields, adds Menifee. Also, real estate is fairly valued now, whereas in the late 1990s and after 2006, it was expensive versus alternatives. Menifee

explains real estate values have only declined during economic recessions since at least 1978, withstanding many prior periods of rising interest rates.

More fundamentally, demand for commercial real estate remains solid, occupancy rates are high, and rents are still growing. These factors will likely support real estate valuations, asserts Schnure.

If interest rates rise moderately, it will not make or break the market, notes Mitch Paskover, president of Continental Properties. Current fundamentals that drive real estate, such as low unemployment and rising wages, remain strong. “Certainly as the interest rates rise, the cost of capital will increase,” he says. “That said, we do not expect the rising cost of capital to subvert the positive state of the market in the short term, unless rates rise significantly.”

And a huge amount of global “dry powder” capital is targeting U.S. commercial real estate, notes Mansour. This global inflow to core assets in gateway markets should prevent any significant increase in cap rates. U.S. real estate is still viewed as blue chip by foreign investors, who are not as sensitive as domestic investors to changes in U.S. interest rates.

Where’s the pain point?

While the short term remains positive, most investors believe multiple increases will eventually lead to a “pain point” for real estate, according to the Seyfarth Shaw survey. No consensus has been reached on where that pain point will be, but 63 percent of respondents say the industry can tolerate up to 150 basis points before the market faces a significant adverse impact.

Investors have been concerned with interest rates throughout the cycle but have had little cause for concern until now, according to Adam Ruggiero, head of real estate research for MetLife Investment Management. “Now that interest rates are becoming a factor, we think quite a few investors are underestimating the potential impact,” says Ruggiero. He believes the market can bear another 50 basis points of spread compression before prices come under pressure, but not much more than that. “If the 10-year Treasury were to move beyond a range of 3.25 percent to 3.50 percent by the end of 2018, value growth could slow considerably,” predicts Ruggiero.

Fed policymakers are increasingly confident in the U.S. economic outlook and synchronized global growth momentum, according to Mansour. She thinks the Fed will continue to reduce monetary accommodation through a combination of balance sheet reduction and hiking the federal funds target rate. The Fed’s reaction function is tied to conditions in the labor market, and as long as labor markets continue to improve, the Fed will continue to raise interest rates, but not as aggressively as historical standards. Mansour expects another three rate hikes through first quarter 2019. “The federal funds rate will ultimately go back to 3.0 percent” she predicts.

Based on this scenario, Mansour does not expect much real estate pain until 2019. Still, real estate is a highly capital-intensive asset class and is quite sensitive to interest rates because it is an investment characterized by high levels of leverage. “If the 10-year Treasury yield goes beyond 3.5 percent, there will be a hit on valuations,” she predicts.

Investor approaches to mitigate risk

What are good approaches to investing in a rising interest-rate environment, and how can investors best protect themselves?

One approach is to focus outside of gateway markets, advises PGIM Real Estate's Menifee. The cap rate spread between gateway and non-gateway markets remains elevated relative to recent norms, and this spread could provide a buffer if interest rates rise.

Invest in market/property sector combinations with the most favorable fundamentals, allowing for greater income growth, suggests American Realty Advisors' Macke. "This should both temper impacts of rising rates and better support capital flows," he says. He also advises focusing on durability of income in knowledge/creation-center markets, which historically have had the highest-growth returns and have recovered faster from downturns.

Interest rates are rising because the U.S. economy is growing faster, labor markets are tight, and accelerating inflation is a concern, emphasizes Mansour. "In this environment, real estate fundamentals should be quite strong, despite headwinds from higher rates," she says. Investment strategy should focus on markets with enhanced growth potential, which may still include gateway markets with high exposure to the tech sector, but also smaller dynamic metros that are attracting tech industries such as Phoenix, and Charlotte and Raleigh, N.C.

Another strategy is to shorten the duration of property leases. As interest rates rise, and if inflation also rises unexpectedly, real estate sectors characterized by long-term leases (such as retail) will underperform, says Mansour. Investors should consider shortening durations and investing in property subtypes with shorter-term leases, such as apartments (with annual leases).

Today, interest rates are anticipated to rise because of economic growth and inflation expectations, according to Martin Liddell, CFO of Starlight Investments U.S. Multifamily. "This is a favorable environment for real estate, particularly apartments, given their shorter average lease terms, allowing operators to capture inflationary gains through market rents on an annual basis," Liddell says.

Assets with growing income streams due to short lease terms and low capital-expenditure requirements are likely to withstand rising interest rates better than assets with flat income streams, adds Menifee. "That favors multifamily and, to a lesser extent, industrial over most office and retail properties," he says.

The best thing investors can do is incorporate the anticipated interest-rate hikes into their overall investment strategies, advises Tim Lee, vice president of corporate development and legal affairs at Olive Hill Group. In addition, he says, investors can buy rate caps if interest rates are going to affect their bottom line. Doing this will provide some predictability. Investors also can tighten the time horizon for their investment, and have a plan B and plan C in place to avoid being dependent on a singular economic environment.

Lee says rising interest rates typically signify a strengthening economy and benefit a value-add and long-term hold strategy. He recommends assets that are well located in strong growth markets where investors can drive value through improving operational efficiencies, increasing rents as tenant leases roll, and capital improvements that further drive overall value and rent growth over time.

Lee also projects investors will shift away from low cap-rate deals in core markets and focus more on secondary markets. "Secondary markets offer better yields and cap rates," he says.

For the multifamily sector, Starlight Investments' Liddell advises focusing on high-quality, well-located assets in markets with strong job, population and economic growth. Asset-management expertise can help generate strong rental and income growth from these assets, which helps mitigate concerns over rising financing costs. Starlight focuses on high-growth suburbs in major U.S. metro areas where income-to-rent multiples and minimal new supply allow for higher risk-adjusted returns. Cap rates are still compressing in these markets.

Fix, float, hedge

As the prevailing interest-rate environment undergoes a shift, borrowers will need to reconsider their strategies, as they compare fixed-rate and floating-rate options as well as duration terms. Investors who have loaded up on short-term debt rather than locking in today's low long-term rates will need to reassess that strategy, says Macke.

For most of this cycle, explains Ruggiero, the smarter move has been to float with the market. But as rates rise and the cycle ages, borrowers increasingly will move to lock in fixed-rate loans. "With so much new capital flowing into commercial mortgages, and the competition that has created, the case for refinancing and locking in a favorable rate now is pretty compelling," he says.

All professional real estate managers manage their loan rollovers, notes Wally Reid, senior managing director and co-head of debt placement for HFF, one of the largest commercial real estate intermediaries in the United States. He says this year and next, many of the insurance companies he works with have limited rollovers. "This suggests that many borrowers have refinanced loans that were coming due in 2018 and 2019," says Reid.

Although interest rate increases historically have been scary for investors, he says, the complex instruments available to today's investor mean a rise in rates does not need to be crippling. Firms such as Kensington Capital Advisors, for example, help investors manage financial and interest-rate risk through appropriate hedging vehicles.

"So when a developer draws on a construction loan, they have the ability to hedge that loan amount if they are concerned about interest rates," explains Reid. "This dynamic is helping to secure profits and values in real estate."

The single most dangerous outcome would be the total market illiquidity that generally accompanies a recession, according to Transwestern's McNearney. "Risk of ruin increases dramatically when there is a maturity default at a time when there are no financing alternatives," warns McNearney. Therefore, it is crucial to build in extension options and avoid maturity concentrations.

Refinancing now also can lock in rates or extend maturities beyond the next two to three years. Annual lease escalations can soften the impact of interest rate increases. McNearney also advises modest leverage levels. Finally, this is a good time to hedge rates, although the cost of futures contracts has risen significantly along with rising rate expectations. The best choice may be interest rate swaps because they have a lower cost to prepay or unwind.

All this said, investors seem better prepared this time around. McNearney says many investors, including state pension funds and sovereign wealth funds, are largely unlevered, and overall leverage levels for leveraged buyers have come down. “There should be less exposure to the risk of ruin caused in other periods, when investors were more heavily leveraged,” he believes.

Impact on lending and housing

Rising rates will have a small impact on commercial and construction lending, predicts Olive Hill Group’s Lee. “Lenders may take a more conservative approach in their underwriting and be more selective in the types of properties they finance,” he says.

This will place a bigger emphasis on a property’s current and projected net operating income. Stable properties with strong income streams will remain attractive to lenders, but higher-risk deals may be more difficult to pencil in as rates continue to rise. But, adds Lee, a wide variety of capital sources will continue to be available for quality properties and value-add deals with strong business plans.

Some lenders will become more conservative in their underwriting as rates rise, but other factors, such as the recent tax reform, likely will have a positive effect on the availability of capital and mortgage flow, which could keep cap rates low, predicts Continental Partners’ Paskover.

While ample capital is still available, terms are getting tougher, even in the tried-and-true multifamily and heavily-in-demand industrial sectors, says Paskover. “The result is an increased need for creativity,” he believes. Today’s borrowers need capital advisers capable of securing competitive loans by addressing lender concerns directly and demonstrating borrower investment strategy with comprehensive analysis.

Rising interest rates may feed into higher borrowing costs this year, but this is not likely to be a one-to-one relationship, believes Menifee. The entrance of new non-bank lenders into commercial real estate, combined with a robust CMBS sector, will keep pressure on margins and provide borrowers with flexibility on other terms, such as amortization schedules and recourse.

Construction lending has been restrained during this cycle, due both to regulatory and self-imposed constraints on banks, notes Menifee. But similar to loans on operating properties, new sources of construction loans may cushion the impact of higher interest rates if margins compress further.

The rise in interest rates, which also drives up mortgage rates, should induce homeowners to lock in fixed-rate mortgages and move away from adjustable-rate mortgages, says The Townsend Group’s Mansour. As a result, the initial impact should be a wave of refinancing. But rising rates’ impact on home prices should be insignificant in the short term. Housing inventory is at all-time lows in a majority of the dynamic metro areas. “Low inventory of homes for sale should limit any harm that rising interest rates have on home prices,” she predicts. New-home supply has been limited as well, so the housing market faces no immediate supply risks.

Any increase in rates will directly impact housing affordability, however, which may offset the increase in demand due to rising wages and employment, says McNearney.

The road ahead

We are witnessing a changing of the guard at the Fed as Powell takes over for former Chair Janet Yellen. Powell and Yellen worked together at the Fed for many years, and Powell never once dissented from Yellen, notes Mansour. But that does not mean Powell will continue on what Mansour calls Yellen's "dovish track." "There is a risk that the Fed under Jerome Powell may overshoot its monetary tightening and tapering," she says.

Of course, no one knows for sure how many more rate hikes there will be going forward, nor how much rates will rise. The path of policy rate hikes will be dependent on U.S. and global growth outlooks, according to Menifee. "Right now, we view that outlook as strong, with more upside than downside, which suggests the Fed will be assertive this year," he says. But clearly many things, including geopolitical events and unpredictable trade negotiations, could cause the Fed to pause at any point ahead.

Concerns about inflation, going forward, are related primarily to the costs of construction materials, which are rising quickly due to many factors, including strong global demand, says Menifee. Materials also may become more expensive with the introduction of new tariffs, such as those recently announced for steel and aluminum. "While this may cause development spreads to compress over the next few years, there is an upside, as a slowdown in the supply pipeline would prolong the income growth cycle further in many markets," observes Menifee.

The biggest risk to the Fed's planned course of action is an escalation in foreign trade actions by the United States and retaliation by global partners, according to Dwight Johnston, chief economist for the California Credit Union League, in commentary published in March. Of course, this has been seen recently between the United States and China, and could develop into a full-blown trade war. This would threaten the economy and could cause the Fed to slow its course of tightening, says Johnston.

On the other hand, if there is a surge in inflation, we could get additional interest-rate hikes. The current year-over-year growth in the core U.S. Consumer Price Index is 1.8 percent, but that could rise. Johnston believes the Fed will tolerate 2.5 percent CPI growth without ramping up tightening, but if it approaches 3.0 percent, the Fed will accelerate the pace. "Under this scenario, the Fed would most likely move rates four times this year and prepare for four next year," wrote Johnston.

Another thing to watch are shifts in foreign central-bank policies; any material changes could affect U.S. Treasury rates as investors weigh the moves in relative yields offered across the globe, according to American Realty Advisors' Macke.

So while the short term looks bright, investors have many variables and moving parts to track. Investors love certainty and predictability, but the one thing that seems certain is uncertainty will continue. The future will favor investors who prepare for numerous economic outcomes.

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