Commercial property outlook in a rising rate environment

With an anticipated federal funds rate hike on the horizon, how will commercial real estate values be affected?

Contributing authors:

Steve Rado is a Principal in Ernst & Young LLP's Transaction Advisory Services practice dedicated to Real Estate M&A Advisory

Dr. W. Michael Cox is the Former Chief Economist of the Dallas Federal Reserve Bank and Professor at Southern Methodist University's Cox School of Business
Introduction: understanding the interest rate environment

As the Federal Reserve looks to normalize monetary policy after a sustained period of exceptionally low interest rates, some commercial real estate (CRE) investors, developers and lenders are worried that CRE values will be negatively affected under the assumption that when interest rates rise, CRE values will fall. This relationship seems intuitive at first – rising benchmark interest rates, like Treasuries, should cause all yield-oriented investments to be less attractive. On closer examination, however, the relationship between interest rates and CRE values is much more nuanced. The trajectory of capitalization rates (cap rates) and real estate values is also impacted by other significant drivers like, demand and supply changes, transaction activity and trends in the overall economy.

At the broadest level, an uptick in the federal funds rate may make it more expensive to develop new projects and refinance certain debt, and possibly engender a reactionary sell-off in publicly traded real estate investment trusts (REITs). And yet, as it stands now, relative to historical averages over the last 30 years, the spread between the 10-year Treasury and CRE yields appears to allow room for further compression, and this suggests that CRE values are not immediately threatened by rising interest rates. This seems especially so as other forces buttress real estate values, like record amounts of inbound capital, available private equity “dry powder,” a generally positive economic outlook (albeit with clear caveats) and strong CRE fundamentals.

Rising interest rates will not immediately threaten real estate values

With a change to monetary policy looming, some have suggested that this will mark the beginning of the end of the current strong real estate cycle. There are at least five reasons to consider why this may not be the case:

1) Historically, there has been no strong correlation between the 10-year Treasury yield and CRE cap rates, and the current spread remains wider than historical averages, suggesting room for compression.

2) The impetus for the Fed’s expected rate hike is improving domestic economic performance.

3) Improving economic conditions should engender stronger CRE fundamentals.

4) Capital flowing into US CRE continues to be robust.

5) A rise in the federal funds rate may not have a substantial near-term impact on the cost of many types of CRE debt.

Interest rates and capitalization rates are not always correlated

Conventional wisdom in the industry is that when US bond yields and interest rates move, cap rate movements will mirror this trajectory, indicating that the two variables are strongly correlated. However, cap rates and Treasury yields historically have not exhibited a strong correlation, even when analyzing their trajectories dating back several decades. In fact, from the 1980s to present day, there have been several instances where cap rates and Treasury yields moved in opposing directions (see Exhibit 1). While cap rates and interest rates do not appear to exhibit a significant correlative relationship, there is meaningful insight to be gleaned from examining the delta between these two yields.

### Exhibit 1: Cap rates historically have not demonstrated a strong correlation with US Treasury yields.

![Graph showing the relationship between cap rates and US Treasury yields](graph.png)

Source: Federal Reserve Economic Data, St. Louis Fed, 2015; Green Street Advisors, 2015.

There is room for compression between 10-year Treasury yields and capitalization rates

The 10-year Treasury rate and cap rate spread is useful because it illustrates the risk premium the market demands in excess of a perceived “riskless rate” (i.e., US Government bonds) to invest in CRE. The narrower the spread, the greater the investor appetite for CRE yields, suggesting a higher risk tolerance. For the major CRE property types, the spread at the end of the second quarter of 2015 was larger than the historical average spread of the last 30 years (from 1986 to the second quarter of 2015). The current spread is also larger than the historically tight spreads that preceded the last peak in July 2007 – and the recession that followed. This suggests that there is room for further compression between Treasury yields and cap rates before the health of the asset class is measurably impaired (see Exhibit 2).

### Exhibit 2: The 2Q 2015 average spread between cap rates and the 10-year Treasury yield was larger than the long run average spread and the lows in 2Q 2007.

<table>
<thead>
<tr>
<th>Product type</th>
<th>Average spread: 2Q 1986-2Q 2015</th>
<th>2Q 2015 spread</th>
<th>2Q 2007 spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office</td>
<td>257 bps</td>
<td>290 bps</td>
<td>1 bps</td>
</tr>
<tr>
<td>Industrial</td>
<td>304 bps</td>
<td>366 bps</td>
<td>134 bps</td>
</tr>
<tr>
<td>Retail</td>
<td>269 bps</td>
<td>350 bps</td>
<td>102 bps</td>
</tr>
<tr>
<td>Multifamily</td>
<td>231 bps</td>
<td>276 bps</td>
<td>49 bps</td>
</tr>
<tr>
<td>Hotel</td>
<td>499 bps*</td>
<td>524 bps</td>
<td>307 bps</td>
</tr>
</tbody>
</table>

| Average      | 286 bps                          | **361 bps**    | 119 bps        |

*Hotel data begins in 4Q 2003.

Source: Federal Reserve Economic Data, St. Louis Fed, 2015; Green Street Advisors, 2015.

It seems likely that the market will be able to absorb incremental rate increases given that the current spread is wider than the long run average, underlying fundamentals are strong and there are other market forces that continue to drive demand to the CRE asset class resulting in lower cap rates and rising valuations.
Improving economic conditions bode well for CRE

When the Fed enacts contractionary monetary policy, it is generally due to high inflation expectations, improving domestic economic conditions or a combination of both factors.

Inflation expectations

While rising interest rates and higher costs of capital are an obvious concern to those investing in CRE, the asset class is an attractive investment because it generally is viewed as a hedge against inflation. This is especially true for property types with shorter lease durations or those that have the ability to reset rates more frequently, such as hospitality and multifamily. Property types with longer-term leases, such as office and retail, may also have rent structures with escalations tied to the consumer price index (CPI) and thereby provide inflationary protection.

However, this characteristic of CRE investments will not likely be the force that drives capital to the asset class in the near term as US inflation expectations remain low, and actual reported inflation measures have been well below the Fed’s formal inflation target of 2%. In fact, inflation expectations, as indicated by the historical 10-year Treasury Inflation-Protected Security (TIPS) break-even rate, consistently have fallen since 2013 (see Exhibit 3).

Exhibit 3: Historical 10-year Treasury/TIPS break-even indicates declining inflation expectations.

![Historical 10-year Treasury/TIPS break-even rate graph](source: Federal Reserve Economic Data, St. Louis Fed, 2015)

Given this outlook, it appears that the impending interest rate hike will not be driven by inflation at the current time. It is important to keep in mind the difference between real returns and nominal returns with regards to interest rates. A real return represents a return that increases an investor’s overall raw purchasing power, whereas nominal returns represent the real return plus a rate of expected inflation. CRE provides protection only from the inflationary component of nominal interest rates.

Holding all other influencing factors constant, a rise in real interest rates would negatively impact CRE values regardless of the lease structure, as a rise in real interest rates would, in theory, cause property valuation discount rates to increase in kind, negatively impacting the value of discounted future cash flows. In reality, all other influencing factors are not held constant and low near-term inflation expectations are coupled with improving domestic economic conditions, which are the basis for solid CRE fundamentals.

Economic indicators point towards growth

While uncertainties abound surrounding wage growth and declines in labor participation rates, the overall economic picture appears positive, and this ultimately bodes well for CRE. Two major indicators of domestic economic growth, the US unemployment rate and the monthly change in US nonfarm payrolls, have been trending positive. From January 2012 to July 2015, unemployment fell 3 percentage points, from 8.3% to 5.3% (see Exhibit 4).

Exhibit 4: The US unemployment rate has consistently declined in recent years.


Similarly, changes in nonfarm payrolls, which account for 80% of all US workers, have increased year-over-year since 2011, implying improving levels of job growth each year (see Exhibit 5). As the economy improves, so too will CRE values.

Exhibit 5: US job creation shows year-over-year improvement.

![US job creation graph](source: US Department of Commerce and Labor, 2015)

New residential housing starts, one of the most closely watched leading economic indicators, reached an eight-year high in July 2015. The US Commerce Department reported that new housing unit starts reached a seasonally adjusted annual rate of 1.2 million, an increase of 10.1% compared to a year ago and 35.3% compared to 2013 (see Exhibit 6).

Exhibit 6: New residential housing starts have approached an eight-year high.

![New housing starts graph](source: US Department of Commerce and Labor, 2015)
CRE fundamentals are strong

In recent years, occupancies have continued to improve while effective rents are growing across the four primary property types (see Exhibit 7). Hotels occupancies and average daily rates (ADRs) have risen past 2007 levels to 67% occupancy and $120 ADR.

Exhibit 7: Since 2012, occupancies and rents have increased across major property types.

<table>
<thead>
<tr>
<th>Occupancy, year-over-year change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multifamily</td>
</tr>
<tr>
<td>2012</td>
</tr>
<tr>
<td>2013</td>
</tr>
<tr>
<td>2014</td>
</tr>
<tr>
<td>2020Q15</td>
</tr>
</tbody>
</table>

Effective rent growth, year-over-year change

<table>
<thead>
<tr>
<th>Multifamily</th>
<th>Industrial</th>
<th>Retail</th>
<th>Office</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>3.9%</td>
<td>1.7%</td>
<td>0.5%</td>
</tr>
<tr>
<td>2013</td>
<td>3.3%</td>
<td>2.1%</td>
<td>1.5%</td>
</tr>
<tr>
<td>2014</td>
<td>3.7%</td>
<td>2.5%</td>
<td>2.0%</td>
</tr>
<tr>
<td>2020Q15</td>
<td>1.9%</td>
<td>3.1%</td>
<td>1.1%</td>
</tr>
</tbody>
</table>


Examining the pipeline: a delicate balance

The balance between supply in the pipeline and demand from CRE users has a profound impact on cap rates. If fundamentals remain strong, demand will follow. The new supply of CRE, measured in construction starts, is below recent peaks and long-run averages. This fact, coupled with continued positive absorption, demonstrates that there is still runway left for construction and new supply before reaching equilibrium. This implies that CRE will benefit from strengthening fundamentals since higher occupancy will not be immediately threatened by new supply in the near-term (see Exhibit 8).

As with CRE valuations and cap rates, there are many factors other than interest rates that influence construction starts. Most importantly, strong economic growth, especially new job creation, mitigates the downward pressure on construction starts resulting from increased interest rates. While construction activity is still in the early stages of recovery in many secondary and tertiary markets, some major gateway markets have experienced a large uptick in construction activity and new supply. Nationally, certain property types, such as multifamily, have led supply gains. With new construction starts nearing historic peaks, this may pose a risk of oversupply.

Other property types, however, such as retail and office, still have plenty of upside potential before nearing recent peaks. Much of the new construction activity has been focused in gateway markets where the risk of supply outstripping demand is most probable. Hotel construction is on the rise as developers seek to meet growing demand stemming from the economic recovery with supply projected to continue to increase into 2016. A rise in the federal funds rate should further assuage fears of overbuilding as construction debt will be pricier with higher short-term bond yields.

Despite higher supply in certain markets and asset classes, net absorption across major asset classes has surpassed or kept pace with new supply since 2012.

While new supply poses a risk for some segments more than others, when considered as a whole, the level of new supply, juxtaposed with demand or absorption, appears healthy. Of course, when underwriting investments, investors must consider local market dynamics, including absorption and oncoming supply, in addition to interest rates.

Exhibit 8: For most major property types, healthy absorption prevails and new completions remain below historic averages.

...
Capital flows at brisk pace

While macroeconomic trends affect the health of the domestic CRE market, property values and investment volumes are also influenced by a host of other factors in today’s environment:

- The influx of international capital into US CRE markets
- Long-term strategic adjustment to asset allocation models
- Larger scale transactions producing value creation opportunities

Foreign capital continues to pour into US CRE markets

Inbound capital is being deployed into US real estate investments in record amounts, and this likely is to continue in the near-term. Foreign capital is drawn to US CRE investment for many reasons, including the predictable cash flows, transparent markets, downside risk protection (based on the relative results during 2009-2014) and relative liquidity. Inbound capital invested into the US CRE market through the first eight months of 2015 has eclipsed 2007 levels. According to Real Capital Analytics, approximately $53.1 billion of inbound global capital has been invested in the US through August 2015. This compares to the $45.6 billion invested for the entire year of 2014 (see Exhibit 9).

Exhibit 9: Foreign capital investment activity in US real estate markets has exceeded the 2007 peak through the first eight months of 2015.

Global pressures and exogenous shocks, such as the unexpected devaluation of the Chinese yuan; declines in the global stock market driven by concerns about the Chinese and emerging market economies; and anxiety about political instability in nations including Greece, Iran and Russia could all affect US CRE valuations. This is because these pressures could cause a “flight to quality” that would apply additional downward pressure to cap rates of domestic CRE investments as foreign capital seeks perceived safer investments that still offer attractive yields, relative to lower-yield US Treasuries. As evidenced by the avalanche of global capital into the sector, foreign investor confidence and the appetite for US CRE are voracious and do not appear to be tapering any time soon. This bodes well for US CRE values, as foreign demand will help drive values higher.

Asset allocations continue to commit to longer term CRE investment strategies

In the 1990’s, most institutional asset allocation models considered real estate a part of an alternative asset allocation strategy. Since then, the CRE sector has become a respected, proven asset class, earning its own piece of the asset allocation pie.

And that pie keeps growing. Prior to 2005, real estate made up less than 5% of the total asset allocation for many institutional investors.2 By 2014, however, real estate made up more than 9% of asset allocations and the expected allocation target for 2015 may be even higher yet, nearing 10%.3

M&A all day

The private equity, hedge fund and owner/operator communities focused on CRE investment strategies have grown significantly in the number of participants and the amount of committed equity since the Great Recession. Recognizing the benefits of CRE ownership, these astute investors are racing to acquire REITs, brokerage and services firms, developers and large portfolios on the heels of rising asset level prices, increased cash flows from underlying assets and improving fundamentals. This is occurring while most REITs are trading at discounts to their net asset values (NAVs) as of August 2015, in spite of strong funds from operations (FFO) growth.

The publicly traded REITs have taken notice as well, with consolidations occurring at an increasing pace. Large scale acquisitions can provide investors with competitive advantages by entering into new markets, adding new competencies and obtaining top talent, while simultaneously optimizing any dislocations in public versus private market pricing of CRE assets. While the pace of transaction activity is somewhat tempered compared to 2004-2007, the activity has been steadily growing since 2010 (see Exhibit 10). Exhibit 10: US real estate transaction volume is gaining momentum.

Expect more leveraged buy-outs involving public REITs going private, REIT consolidations and strategic investments. The availability of capital, strong CRE valuations and a positive economic outlook should keep M&A activity buoyant in the near term.

A fed funds rate hike may not raise CRE borrowing rates substantially

CRE investors face a variety of choices today when borrowing to finance their projects. Historically, much CRE debt was priced off the bank’s prime rate. However, as the asset class has become increasingly institutionalized, CRE loan pricing has become more dynamic, with providers of debt offering rates pegged to a variety of other observable market rates, notably 5-, 10- and 20-year Treasuries for long-term debt and the one-month London Interbank Offered Rate (LIBOR) for shorter term or construction debt. Other rates used to price commercial loans tend closely to track Treasury rates of equal maturity, so Treasury rates can be used as a surrogate for analyzing movements in these rates as well.

Moreover, there has been significant growth in the availability of capital from nontraditional lenders, including hedge funds, business development companies, sovereign wealth funds, private equity debt funds, life insurance companies and mortgage REITs, as well as a host of opportunistic mezzanine lenders. This is, in part, due to a recoiling from massive losses incurred by traditional financial institutions during the financial crisis, greater regulatory oversight and increased demand for capital to fund investments in an asset

---

2 David J. Funk, Real Estate Takes Its Place as the Fourth Asset Class, National Association of Industrial and Office Properties, 2015.

class that is becoming increasingly institutionalized on a global stage. These nonbank lenders provide a diverse array of CRE loans, which may not tie their lending rates so closely to rates in short-term markets.

Rates typically used as market indicators do not always move with the fed funds rate

In examining the one-month LIBOR and the 5- and 10-year Treasury rates during the period from 1982 to today, it is evident that increases in the federal funds rate do not precipitate a predictable pattern of behavior for corollary rates. Of course, this is primarily a function of duration, and it’s certainly no surprise that the one-month LIBOR most closely tracks the movement of the federal funds rate. Consequently, CRE debt priced as a floating spread over LIBOR, such as debt used for construction activity, repositioning strategies and distressed assets, will exhibit more immediate and dramatic exposure to an increase in the federal funds rate. Any downward pressure on construction activity engendered from these higher rates should help mitigate concern of an overheated CRE market because it will make it harder for new gluts of supply to outpace demand.

Exhibit 11: The Bank prime rate, LIBOR, and 5- and 10-Year Treasury rates have not historically moved in lock-step

![Chart showing change in yield (%)](source: Federal Reserve Economic Data, St. Louis Fed, 2015).

Predictably, the 5-year Treasury is less affected by changes in the fed funds rate, especially in the most recent period of rising rates from May 2004 to July 2007. During that period, the federal funds rate increased 425 bps, the 5-year Treasury rates rose by only 88 bps and the 10-year Treasury rates rose by only 6 bps (see Exhibit 11).

While monetary policy during this period is somewhat unique in that it preceded a massive financial crisis and was correctional in nature, there are reasons to believe that a federal funds rate increase today would not have a substantial effect on longer-term rates and, thus, on CRE loan rates in today’s environment. Interest rates on Treasury notes tend to be tied closely to inflation expectations over the term to maturity of the note. However, CPI inflation has averaged just 0.2% during the past 12 months and shows no signs of increasing in the near-term.

Recent stock market volatility and economic weakness abroad will continue to direct capital away from riskier alternatives and toward the safe haven of US Treasury securities. But in today’s economic environment, the global demand for US Treasury securities likely is quite elastic, requiring less of a rate increase to equilibrate supply and demand.

The mechanism by which a federal funds rate hike drives up longer-term rates is simple supply and demand, which is why an increase in today’s federal funds rate may not have a substantive impact on longer-term rates. Higher short-term rates attract investors away from longer-term securities, reducing long-term security prices and increasing their yield. A federal funds rate increase today is likely to have less of an effect on long-term rates and on CRE borrowing costs than in many previous episodes of federal funds rate increases.

Conclusion

The fervent discussion of upcoming Fed actions and the rising interest rate’s effect on domestic CRE has been somewhat overwrought. The Fed’s initial policy adjustments likely will have only a marginal impact on CRE valuations and investment momentum. A shock to the US CRE investment environment from a 25 to 50 bps increase in the overnight lending rate seems unlikely in light of the forecasted environment for the sector. With vacancies trending down in office, retail and industrial properties and hospitality and multifamily exhibiting increased rents, the effect of contractionary monetary policy and rising interest rates on real estate values and cap rates should be mitigated in the near term, especially for investors focused on cash flows from strengthened operations.

While many purport a negative outlook for CRE based on the premise of spiking long-term interest rates, there is merit to consider the possibility that long-term interest rates will exhibit only moderate growth in the near term, given the slower pace of the US economic recovery. Given the context of the increased capital supply and strong fundamentals in confluence with the notion that there is room yet for compression in the spread between cap rates and interest rates, CRE will persist to be an attractive investment on a risk-adjusted basis in the near-term.

However, investors should be judicious in underwriting risk as trophy assets in gateway markets appear to be fully priced with new supply coming at a faster pace. Expect to see investors looking aggressively to primary and secondary markets to find value as US CRE assets are well positioned fundamentally.

Actions of the Fed to normalize interest rates should not be seen as a bane for the industry, but rather should instill confidence that their efforts are a proactive measure to provide stability in the future. On the aggregate, the lessons learned from the Great Recession, coupled with greater regulatory oversight, will temper the investment zeitgeist. This will provide a positive investment environment for US CRE.
EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

About EY’s Global Real Estate, Hospitality & Construction Sector

Today's real estate sector must adopt new approaches to address regulatory requirements and financial risks, while meeting the challenges of expanding globally and achieving sustainable growth. EY’s Global Real Estate, Hospitality & Construction (RHC) Sector brings together a worldwide team of professionals to help you succeed – a team with deep technical experience in providing assurance, tax, transaction and advisory services. The Sector works to anticipate market trends, identify the implications and develop points of view on relevant sector issues. Ultimately it enables us to help you meet your goals and compete more effectively.

© 2015 Ernst & Young LLP.
All Rights Reserved.

SCORE no: CE0920
1508-1633897

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

ey.com/us/rhc