WHITE PAPER

Interest Rates and Commercial Real Estate – What to Know in 2015!

Introduction

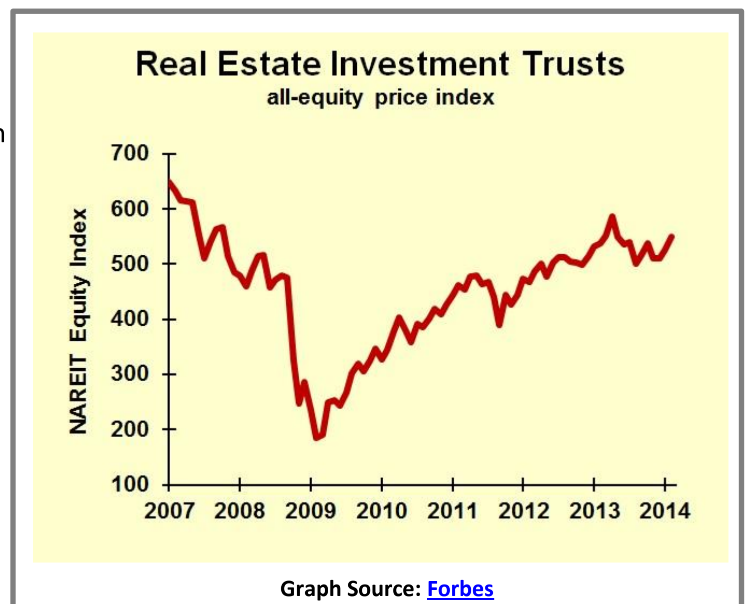
For several years now, I have seen how heavily interest rates affect the value and deal strike points of a commercial real estate transaction. I have been helping clients position themselves with the expectation that interest rates are going to rise. While rising interest rates do apply downward pressure on values and appreciation of assets in the short-term, I wanted to review historically what effect rising rates have on values in the long-term. I was surprised at the findings and I do think this applies heavily to the decisions my clients will be making in 2015 in regards to their commercial real estate holdings.

Current Market Environment

U.S. interest rates are astoundingly low and have been for quite a long time. But it can't last forever and some investors are worried. Their fears are rooted in the perception that rising interest rates will cause capitalization (cap) rates to rise and thereby weaken property values and commercial real estate investment performance.

Public equities, real estate, agricultural land and private equity investments have enjoyed strong returns since 2009, which has largely synced up with the Quantitative Easing (QE) program introduced by the Federal Reserve (the Fed).

With the Fed first hinting in May 2013 at "tapering" and beginning to cut back on QE, the rate on the ten-year U.S. Treasury note has risen to approximately 3 percent today (an increase of approximately 150 basis points from July 2012). This has caused unease with investors, particularly in real estate, where some fear that cap rates may rise, signaling the beginning of a real estate correction.



Graph Source: Forbes

While seemingly a matter of straightforward arithmetic, these worries are overblown because they ignore variables that have the potential to offset value declines. In fact, there are a number of factors that may provide protection to overall property performance in a rising interest rate environment.

Over the past two years, the Fed has been buying tens of billions of dollars in bonds and other securities each month. But it said in September 2014 it would buy $15 billion in mortgage and other bonds in October and then stop the program.

Rising commercial mortgage interest rates hurt investment property values in 2013, as shown by real estate investment trust (REIT) prices. They have recovered somewhat thanks to strong operating earnings. Combining appraisals of institutional properties with operating earnings indicate that total returns in 2013 averaged 11 percent. That's higher than the nine-percent long-run average.

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Interest Rates and Commercial Real Estate

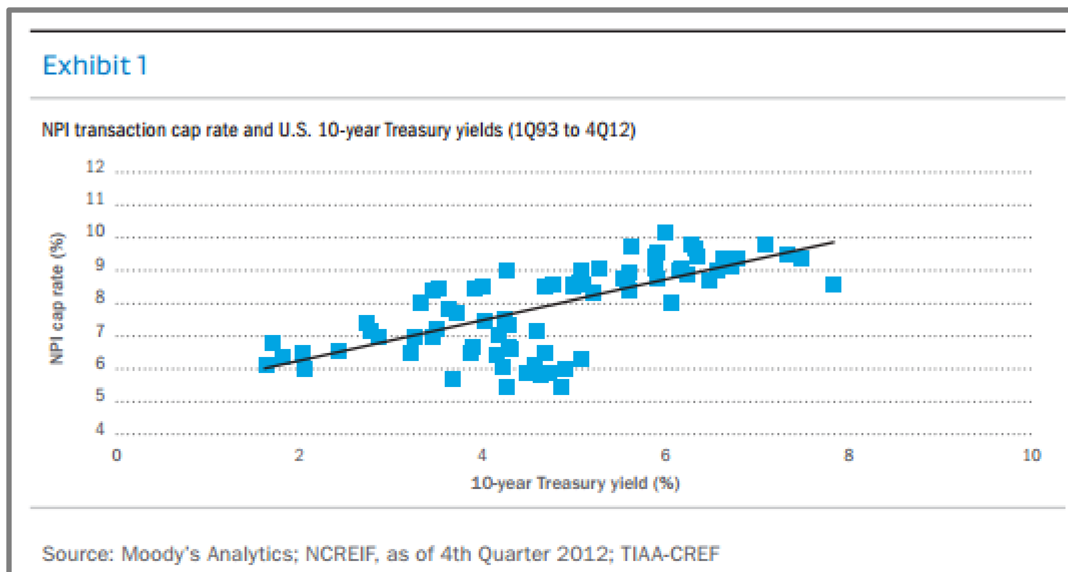
Forbes reports that private non-residential construction is growing at a fairly strong pace. Total dollars spent have increased by nearly ten percent in the past 12 months. Non-residential real estate values should rise at a modest-to-moderate pace in 2015-16, with stronger operating earnings partially offset by rising interest rates.

The outlook for non-residential operating returns is very positive. The expanding economy will boost occupancy and provide opportunities to increase rents. There is relatively little new supply coming to market in most cities, so landlords will be in the catbird seat for a few more years.

Property values are a little tougher to anticipate. On the plus side, higher operating revenue should boost values. On the negative side, higher interest rates will be a downward force. Past experience argues for rising values in this type of market, but don't expect appreciation to be as strong as the rise in earnings.

Interest Rates and Treasury Yields

Exhibit 1 focuses on the relationship between interest rates and cap rates, with a display of National Council of Real Estate investment Fiduciaries (NCREIF) Property Index (NPI) transaction cap rates and US 10-year Treasury yields using data for the past 20 years. A rough positive relationship is evident between the two variables as demonstrated by the black line imposed on the scatter.



However, that rough relationship does not mean that cap rates change in lock step with Treasury yields. The correlation between the two variables is not a perfect 1.0, but rather a moderate 0.6. More importantly, historical data show that changes in Treasury yields do not necessarily result in changes in cap rates.

Cap rates are influenced by a wider network of variables beyond interest rates.

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Cap Rates Are Affected by Multiple Variables

Spreads Matter

In practical terms, the difference, or spread, between cap rates and 10-year Treasury yields is typically sizable and has the potential to act as a buffer that can absorb increases in the 10-year Treasury yield without corresponding increases in the cap rate.

Economic Growth Matters

In today's environment, the most important factor that is overlooked is that interest rate increases are anticipated to coincide with strengthening economic and employment conditions.

Real GDP growth is expected to strengthen from 2.1% in 2013 to a more robust 2.7% in 2014, and to an intermediate-term trend of 2.8% over the 2015 to 2019 period, according to TIAA-CREF.[1] The third-quarter 2014 GDP estimates of the Bureau of Economic Analysis show the growth rate in U.S. output in the second and third quarters combined produced the best six-month growth period for the economy since late 2003.[2]

The resumption of stronger growth is expected to reduce the unemployment rate as well, to below 6% by 2018. The expected economic and jobs strength has positive implications for real estate occupancies, rent growth, and operations that can help offset, at least partially, any adverse price impacts of rising cap rates.

An improving labor market is one of the main factors driving the current rise in consumption and consumer sentiment (see *Exhibit 2*). A total of 8.4 million payroll positions on a seasonally-adjusted basis have been added to the national economy during the past five years. The 2014 national payroll job change is averaging +227,000 a month.[3] Consequently, the jobless rate has fallen. The national unemployment rate stood at 5.9 percent as of September 2014, slipping below 6 percent for the first time since July 2008.

[1] "Cap rates rising: Fear and loathing in real estate" by Martha Peyton and Edward F. Pierzak. TIAA-CREF.

[2] "ARE YOU READY FOR 2015?" by Mark Doran. Transwestern. Q4 2014.

[3] "THE HEALTH OF THE U.S. CONSUMER AND COMMERCIAL REAL ESTATE" by Racehlle Sarmiento. Transwestern.net. Q4 2014.

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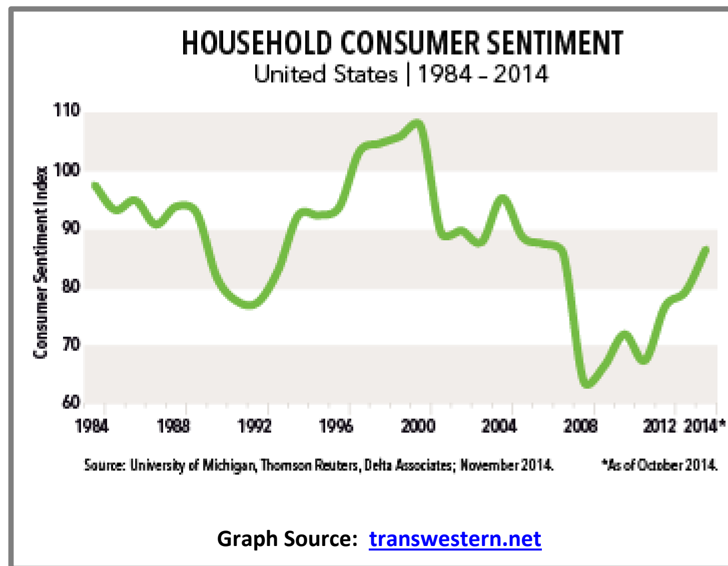
Exhibit 2



Graph Source: transwestern.net

Although wage growth has remained stagnant during the current economic recovery, falling unemployment should slowly increase competition for talent, eventually accelerating income growth.

Real estate performance is less sensitive to cap rate changes as the investment horizon lengthens. However, if cap rates rise in line with interest rates, they can have a dramatic impact on property performance in the near term. Thus, the timing of cap rate changes matters and time has the potential to heal most, but not all, wounds from rising interest rates.

Therefore, the feared environment does not have to translate into catastrophic real estate performance. Fears that the eventual rise in interest rates will result in higher cap rates and declining property values are only justified if everything else is assumed to be unchanged. While this assumption might seem reasonable, it oversimplifies the more complex nature of reality and ignores factors that have the potential to offset value declines. As a result, investor fears are likely exaggerated.

Interest Rates Rise Because of Strong Demand

Interest rates on mortgages, bonds, and other long-term debt are determined by two factors: inflation expectations and economic growth, which combine to set the supply and demand for credit.

Interest rates only rise when the economy is strong or inflation is accelerating, according to Bill Conerly of Forbes.[4] At these times, investors are confident. They borrow more because prospects for investments look good. The factors that push up interest rates are the same factors that push up investment values. Interest rates rise because of strong investment demand.

[4] "Commercial Property Values With Rising Interest Rates" by Bill Conerly. Forbes.com. August 2, 2013.

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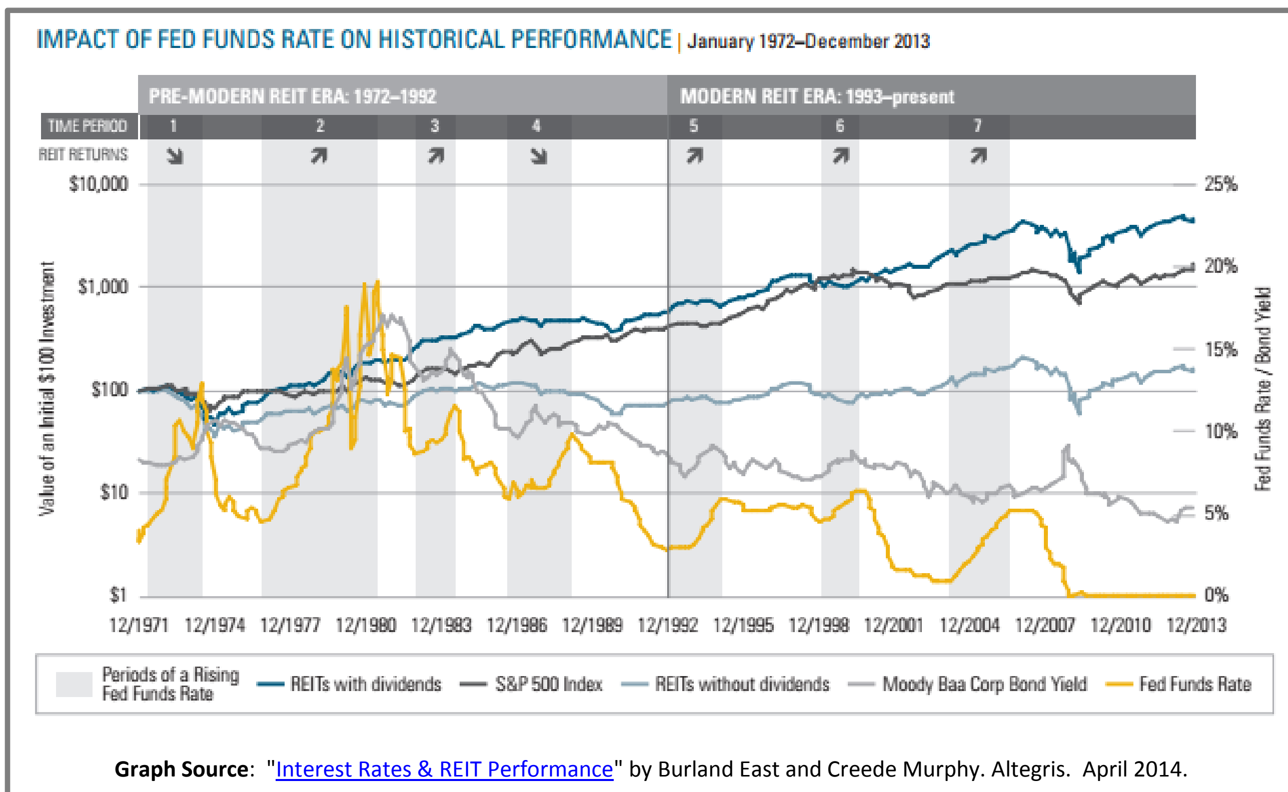
Performance of Real Estate Investment Trusts (REIT)

“How do REIT share prices perform while interest rates are increasing?” This is a logical question, as the returns associated with traditional fixed income oriented products, like bonds, are strongly correlated with rate changes. Many looking for income oriented products wonder if REITs behave the same way. After examining seven distinct periods of rising Federal Funds rates, it appears the answer is no.

A rising Fed Funds rate represents tightening and usually corresponds to the Federal Reserve (“Fed”) fighting inflation or the threat of inflation.

Figure 1 shows the history of REIT returns, S&P 500 performance, Moody’s Baa corporate bond yield and the Fed Funds rate since 1972. The data suggests an increase in the Fed Funds rate may not be a driving force behind the movement of REIT prices.

<u>Figure 1</u>



Graph Source: "Interest Rates & REIT Performance" by Burland East and Creede Murphy. Altegris. April 2014.

Admittedly, rising rates can temporarily generate headwinds for yield-sensitive asset classes such as REITs. However, over time REIT shares typically benefit from the underlying forces that cause rates to move higher – namely, positive economic growth.

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Interest Rates and Commercial Real Estate

Seven Periods of Rising Rates

Pre-Modern Era: 1972

The pre-modern REIT era was characterized by fewer, smaller REITs that were essentially passive owners. This era saw four periods of dramatic and sustained increases in the Fed Funds rate. REITs experienced a positive return in two of these periods and negative returns in the other two.

Period 1: 1972 to 1974

During this period, the Fed Funds rate increased from 3.3% to 12.9% and REIT returns were dismal. REITs including dividends were negatively correlated with the increase in the Fed Funds rate, losing 39% of their value. This, of course, corresponds to the 1974 bear market, which up until now, was the worst downturn since the depression.

Period 2: 1977 to 1981

This was the Volker Squeeze. Interest rates made any financed transaction essentially impossible, as turbulent monetary and fiscal policy, the end of the Vietnam War, a massive recession, an oil shock, and a paralyzed government all contributed to a spike in the Fed Funds rate from 4.6% in 1977 to 19.1% in 1981. During these unsettled times, REITs including dividends were positively correlated with rate changes and gained 110%.

Period 3: 1983 to 1984

During this period, the Fed Funds rate increased from 8.5% to 11.6%. REITs including dividends gained 23%.

Period 4: 1986 to 1989

During this period, REITs including dividends lost 3.3% as the Fed Funds rate increased from 5.9% to 9.9%.

The Modern Era: 1993 to present

Most publicly traded REITs around today were not formed before 1993. This era saw three distinct periods of rising Fed Funds rates, in which REITs experienced positive returns in all three.

Period 5: 1993 to 1995

The Fed Funds rate increased from 2.9% to 6.1% during this period, and REITs including dividends gained 21%.

Period 6: 1999 to 2000

The Fed Funds rate increased from 4.6% to 6.5% during this period, and REITs including dividends gained 17%.

Period 7: 2004 to 2007

The Fed Funds rate increased from 1.0% to 5.3% during this period, and REITs including dividends gained 99%.

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Throughout the seven periods of rising rates since 1972, REIT including dividends share prices increased in five of them and declined in two. Therefore, unlike other traditional fixed income products, an increase in the Fed Funds rate will not necessarily cause falling prices. Rather, strong underlying assets, possible inflation, and increases in growth of key operating metrics drive increases in REIT prices.

Because the vehicles raise debt frequently to fund the acquisition and development of new properties, they suffer when the cost of debt rises via higher interest rates. In all, REITs raised $15.2 billion in debt in the third quarter, down $17.5 billion from last quarter but up 12% from the same quarter last year, according to a September report in the *Wall Street Journal*.[5]

The yield on the 10-year Treasury note, a common benchmark for interest rates on real-estate debt, fell from 3% at the beginning of 2014 to below 2.4% at the end of August, but then rose in September, hitting 2.6% by the middle of the month.

Current Opinions

"If rates move up too quickly, they could end up choking things off," said Steve Sakwa, a REIT analyst with International Strategy & Investment Group LLC. "With the Fed's bond-buying program, they had the pedal to the metal, and they're clearly pulling it off."

National Association of Realtors chief economist Lawrence Yun said during the November 2014 REALTORS® Conference & Expo, "I am of the view the Federal Reserve will increase interest rates sooner, because rents, a major component of consumer price inflation, [are] rising strongly," he said, predicting that the central bank could raise the benchmark Federal Funds rate as early as next April.[6]

Mortgage rates can be expected to rise as a result of the Fed's shift in policy, which means that for capitalization rates to rise, landlords will have to raise rents, or property prices will have to decline, Yun said. "Property owners should be not overly concerned, but they should be monitoring what will happen to prices" as the Federal Reserve reacts to improvements in economic conditions.

Another issue that commercial property practitioners need to watch is the availability of credit. Financial institutions that traditionally cater to real estate investors involved in relatively small deals, such as credit unions and local banks, are reluctant to make loans because of new government regulations that govern lending, Yun said. "Community banks are feeling strangled by all the regulations coming from Washington."

Not everyone is getting excited about it like others. Rising rates suggest a strengthening economy, which could benefit REITs later.

[5] "Expectations for Rise in Rates Pummel REITs" by Robbie Whelan. Wall Street Journal. September 30, 2014.

[6] "Commercial Real Estate Sector Rising" by Sam Silverstein. REALTOR Magazine. November 10, 2014.

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The *Wall Street Journal* offers a good example from just last month (Nov 2014). "Over the past few weeks you've seen some uncertainty, but it's probably just a slight correction," says Paul Habibi, a professor of real-estate finance at the UCLA Ziman Center for Real Estate. "Quantitative Easing is ending, but if you look at the bigger picture, it's because we're heading for better times, which means higher rents and occupancies…It's important in the short-term, but it's also emblematic of long-term economic strength. Markets in the short-term are myopic in that sense."

Factors Affecting Cap Rates

Key inferences can be drawn on what other factors have historically affected cap rates.

Credit Availability

In the period from October 1998 to May 2000, U.S. Treasury rates increased 191 basis points while the stock of U.S. commercial real estate mortgages rose by over $450 billion. This resulted in a fall in cap rates of 32 basis points over the same period and 5 basis points, one-year forward, according to Morgan Stanley.[7] In contrast, during the early 1990s (December 1989 to October 1990), U.S. Treasury rates increased 88 basis points, while lending stock scaled back by over $50 billion. In this instance, cap rates increased by 68 basis points over the same period and 150 basis points, one-year forward.

The Supply-Demand Dynamic

During the late 1980s, supply grew well ahead of potential demand. From 1985 to the end of the decade, approximately 700 million square feet of office came online versus absorption of 526 million square feet. Further, construction financing grew at a compound annual growth rate of 23.5 percent between 1984 and 1988.

Looking at the lead up to the GFC, approximately 262 million square feet of office came online while absorption was only 48 million square feet. This time around, construction financing grew at approximately 18 percent between 2004 and 2008 as condo conversions and residential housing projects exploded in growth. Essentially, the glut of supply and pullback of credit led to a rise in cap rates in the early 1990s, whereas a large fall in demand (starting in 2008) coupled with little credit availability caused the most recent rise in cap rates during the GFC.

Inflation

The recent rise in interest rates (since mid-2012) has largely been a change in the real yield. If the cause of further increases in U.S. Treasury rates emanates from an increase in inflation, real estate values may not necessarily fall materially.

Real estate has the potential to offer partial inflation protection, as higher cash flow from rents or income may offset any rise in cap rates. Inflation, however, has not shown any material increase so far. What may further mitigate a potential rise in cap rates though, even if inflation does not increase, is the fact that current cap rate spreads to

[7] "Frozen on the Rates: Impact of Interest Rates on Capitalization Rates" Morgan Stanley. January 2014.

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sovereign bond rates in many countries are well above their historic means. This may act as a buffer for real estate value changes in a rising rate environment.

The picture today shows that these other variables may mitigate or potentially offset any rise in cap rates. Credit availability is growing, construction lending has been muted, demand is outpacing supply broadly and spreads have been wider than historic means. So far, inflation-led growth has been a missing ingredient. ***End Report***

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