SPECIAL REPORT

Capital Markets: Back to the Future

IPA INSTITUTIONAL PROPERTY ADVISORS

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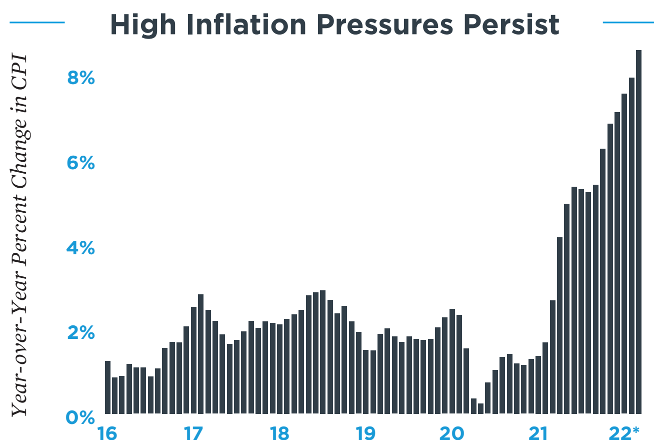
Fed Takes Page from Past Playbook, Raising Interest Rates; Commercial Real Estate Expected to Perform Well

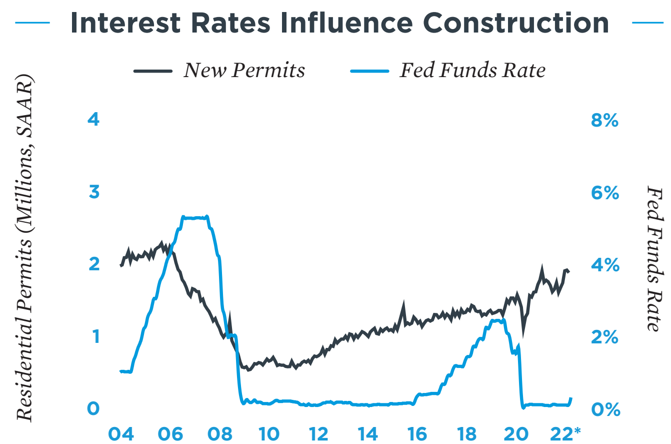
Federal Reserve officially kicks off period of rising rates. On Wednesday, March 16, the Fed approved a 25-basis-point rate increase, the first since December 2018. While the hike was a bit of a reality check for commercial real estate owners and lenders alike, the main cause of concern was the FOMC's post-meeting comments. This release verified inflation concerns and the many rate hikes that may be coming over the next year and a half to alleviate them. The Fed also indicated the possible magnitude of the rate hikes. Based on recent comments by Chairman Powell, it seems likely that the Fed will increase rates by another 50 basis points in early May, with potentially another five or more hikes resulting in a Fed Funds rate in the 1.90 percent to 2.50 percent range by the end of the year. Some forecasts expect even more rate increases in 2023.

Expected rate trajectory still below historical levels. Despite various concerns, it is important to view these rate hikes in historical context. At the pinnacle of the last real estate cycle in 2005-2006, prior to the Great Financial Crisis, the commercial real estate market was clicking away with a Fed Funds rate as high as 5.30 percent, and a 10-year Treasury Rate as high as 5.23 percent. That is still below the average 10-year Treasury Rate of 6.07 percent over the past 50 years. While the Fed Funds rate has hovered around zero for more than a decade, the planned Fed hikes will still keep interest rates at relative historical lows. It may have an impact on a market that has seen cap rates compress and construction costs rise, due to a low interest rate environment. Despite this, history demonstrates it is possible to have a strong commercial real estate market in a higher rate environment than many currently contemplate.

Fed policy emphasizes existing debt. Borrowers seeking new mortgages are noticing a bevy of changes, due to these projected rate hikes. Forward interest rate projections are aggressively steep, resulting in higher interest rate cap costs and high swap spreads. Securitizations following last March's hike are only getting started, but initial feedback is that spreads are nearly even, despite a greatly increased base index rate. If this trend continues, interest rates will move back toward the mean, and that makes assumable debt that was originated over the past few years incredibly valuable and accretive to the next buyer. Some of the sub-debt that was raised during the pandemic might finally find a home in acquisitions of assets stacked on top of assumable debt, as the blended cost of capital may be cheaper than a full leverage permanent loan in the coming years.

Rising rates could disrupt construction. As lending costs rise, cap rates may increase to make cash on cash returns feasible to core holders. This suggests that either construction and land costs would decrease, or development could slow. Depending on what happens with job growth, income growth and the economy in the coming months, this could result in an even greater supply/demand imbalance for the residential and industrial sectors, as well as other property types. During the last two periods of Fed rate hikes, from 2005-2006 and 2015-2018, residential permitting continued to increase throughout the rising interest rate environment. Construction of non-residential properties also had expansionary momentum in those spans; however, in the early 1980s, when the overnight lending rate was higher and rose more rapidly, residential construction permitting did slow.





** Permits Through February; CPI and Fed Funds Rate Through March*
Sources: BLS; Federal Reserve; The Conference Board

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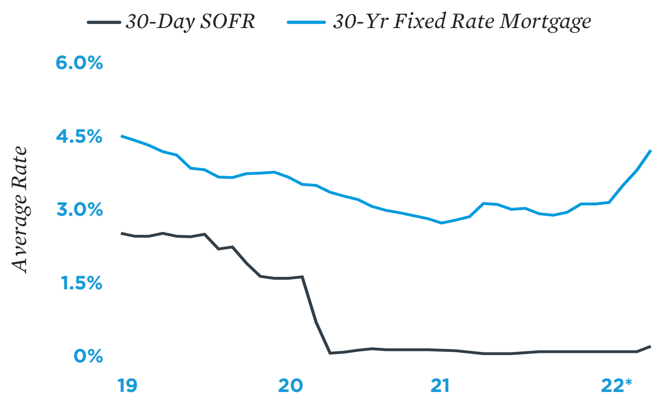
Interest Rates Firmly Set on Upward Path; Investors Execute Plans Accordingly

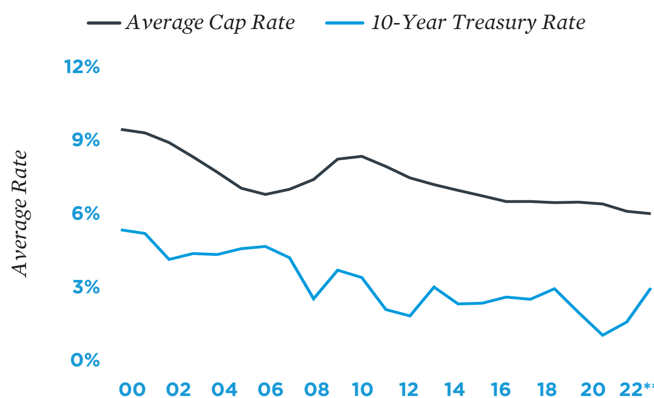
Multiple strategies available for investors. Action plans become even more important in times of volatility and uncertainty. Both owners of existing properties and investors planning new purchases are looking to lock in low interest rate financing while it is still available. While real estate owners may scoff at today's lending rates, spoiled by the incredibly low interest rates of the last few years, rates today are still at historic lows, and indications suggest they may not decrease any time soon. Rate locks at application and forward rate locks are becoming a more important consideration than rate or leverage for many. This makes Life Company debt a much more attractive option than risking a major retrade, prior to closing a CMBS execution. One of the bright spots of the recent rate hike is a decreased defeasance cost for loans that are currently securitized. More owners may consider refinancing loans that are a year or two from maturity, paying the reduced defeasance cost, and recasting the loan for more term at what are still historically low rates. For transitional assets, rates are still very appealing, though steadily widening. It still makes sense to execute now before the risk of cap rate decompression and debt yield expansion plague higher-proceed alternatives. For development deals, getting a project out of the ground now may result in reduced competition and supply concerns by the time the project opens.

Rates are unlikely to decrease in the near future. While nobody can predict the future, there are enough signs and evidence that the current low rate environment may be coming to an end for this cycle, given inflationary pressures. There are steps owners can take now to preserve asset value through accretive debt that is still at historical lows, despite the recent rate hike. Owners focusing too much on the conditions of the past decade, who are waiting for rates to become significantly lower, may find themselves in a more difficult position down the road, when rates are significantly higher and regressing to the historical mean.

Interest Rate Trends



Cap Rate vs. Treasury



** Through March*
*** Preliminary estimate as of April 18, 2022*
Average cap rate for transactions of apartments, offices, retail and industrial
Sources: IPA Research Services; BLS; CoStar Group, Inc.; Federal Reserve; Freddie Mac; Real Capital Analytics

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Sales data includes transactions priced at $1,000,000 and greater unless otherwise noted. The information contained in this report was obtained from sources deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guaranty, express or implied, may be made as to the accuracy or reliability of the information contained herein. This is not intended to be a forecast of future events and this is not a guaranty regarding a future event. This is not intended to provide specific investment advice and should not be considered as investment advice.

Sources: Marcus & Millichap Research Services; Federal Reserve; Freddie Mac Primary Mortgage Market Survey; CoStar Group, Inc.; Moody's Analytics; MNet; Real Capital Analytics; RealPage, Inc.; U.S. Bureau of Labor Statistics

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