What's Next for Private Real Estate?

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WHAT'S NEXT FOR PRIVATE REAL ESTATE?

Private real estate has become an unintended victim of the Fed's fight against inflation in recent quarters, with values dropping amidst a rapidly rising interest rate backdrop. As the asset class has come to represent a meaningful share of the investment universe, the question is "what happens next?"

Why Are Higher Interest Rates Hurting Real Estate Values?

Two areas where rising interest rates impact the value of commercial real estate are the cost of debt and relative yields.

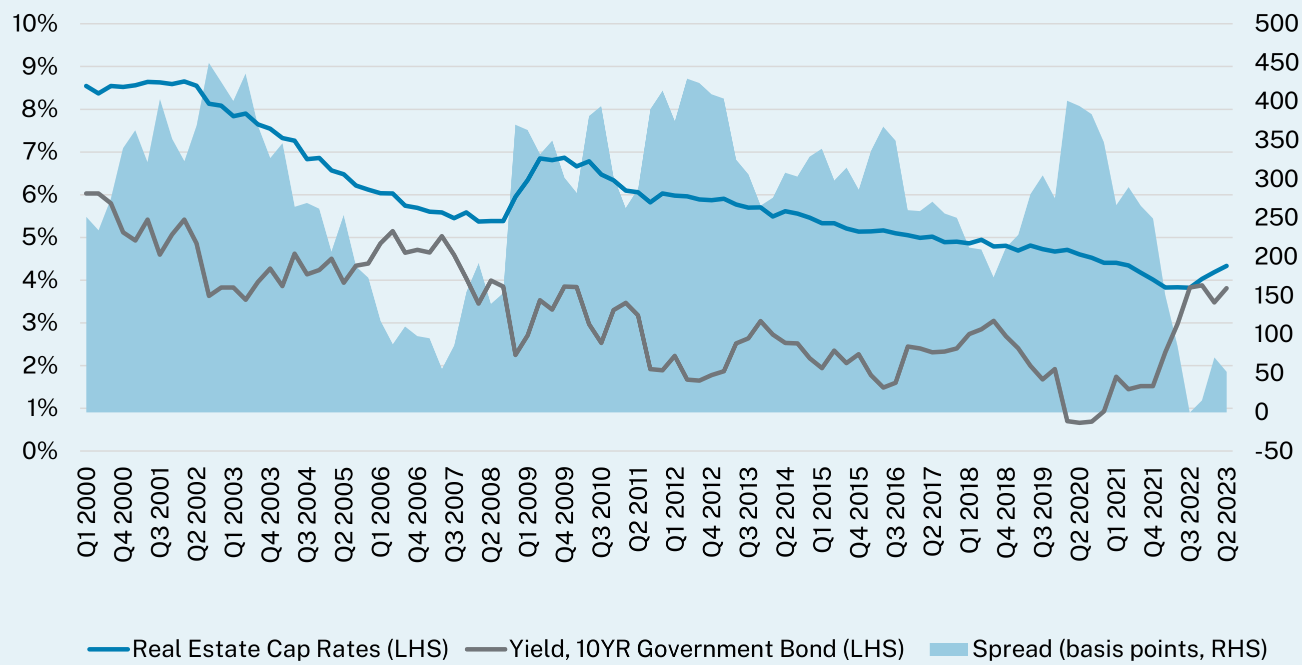
As interest rates increase, the cost to borrow goes up. You may have seen this if you or someone you know has recently applied for a home mortgage – the rates on a 30-year fixed-rate mortgage have increased from 3.3% in August of 2021 to 7.54% as of August of this year[1].

The same holds true for commercial real estate – today's buyers will find it more expensive to finance a commercial investment property. Similarly, higher interest rates usually mean a borrower will need to contribute more equity, which can price certain purchasers out of the market, thereby reducing demand. Both contribute to downward pressure on prices.

The relative attractiveness of real estate's income returns are often measured as a spread to the risk-free rate, or long-term Treasury yields; when interest rates are low (such as from after the Global Financial Crisis until COVID), real estate cap rates can compress and still continue to represent an attractive investment (Figure 1). When interest rates rise, however, the spread shrinks; this reduces the attractiveness of real estate yields because investors can get a comparable yield from a less-risky asset (like a bond). Real estate is thus forced to reprice to maintain an appropriate spread.

FIGURE 1

Real Estate Cap Rates and Spread to the U.S. 10-Year Yield, 1Q 2000 – 2Q 2023



Source: American Realty Advisors based on data from NCREIF and Macrobond as of October 2023

1 Source: Bankrate and Macrobond

When Will Values Start to Improve?

This is the trillion-dollar question. While no one knows the exact point at which values will reach their trough and begin to increase, we do know the conditions necessary to reverse course, and history gives us a helpful guidepost for understanding what may happen to values when we do turn the corner.

For starters, transaction volumes need to resume more meaningfully. Greater deal flow provides a deeper data set for buyers and sellers to lean on to determine the appropriate value of their asset through similar sales. Greater pricing transparency leads to greater conviction to transact, which in turn enhances transparency – this feedback wheel needs to start turning again for values to increase.

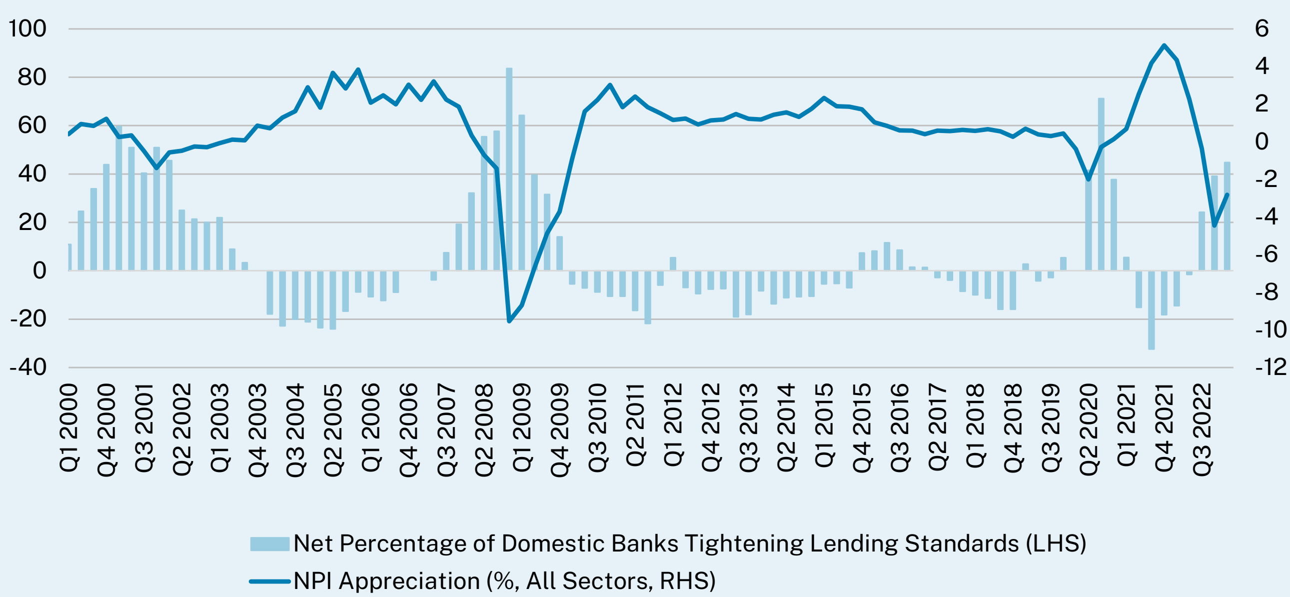
Confidence in pricing is also being driven by differing views on the trajectory of the economy and interest rates from buyers and sellers. Whereas in a functioning capital markets environment the bid-ask spread (the difference between what buyers are willing to pay and what sellers are asking for) is relatively narrow, today that gap has widened so much that the volume of closed transactions has plummeted because buyers and sellers simply cannot agree. Sellers are holding asking prices higher on the belief that rates will move lower in the near term; buyers, recognizing the potential for higher-for-longer rates and a recession, are pricing in higher relative risk premiums and lowering their offers. Until there is greater clarity on where interest rates and the economy will settle, both parties are likely to hold their position, preventing the wheel from turning.

A more certain outlook should also start to add more grease for this wheel in the form of an easing in lending conditions. Why? Because greater debt availability will bring more willing buyers to the table, which would reignite competition for assets and improve pricing.

We can see how this has played out historically in Figure 2. In periods where a greater number of banks are tightening lending standards (when the bars are rising), appreciation (reflected by the line) declines; this is especially pronounced when there are large swings in access to credit.

FIGURE 2

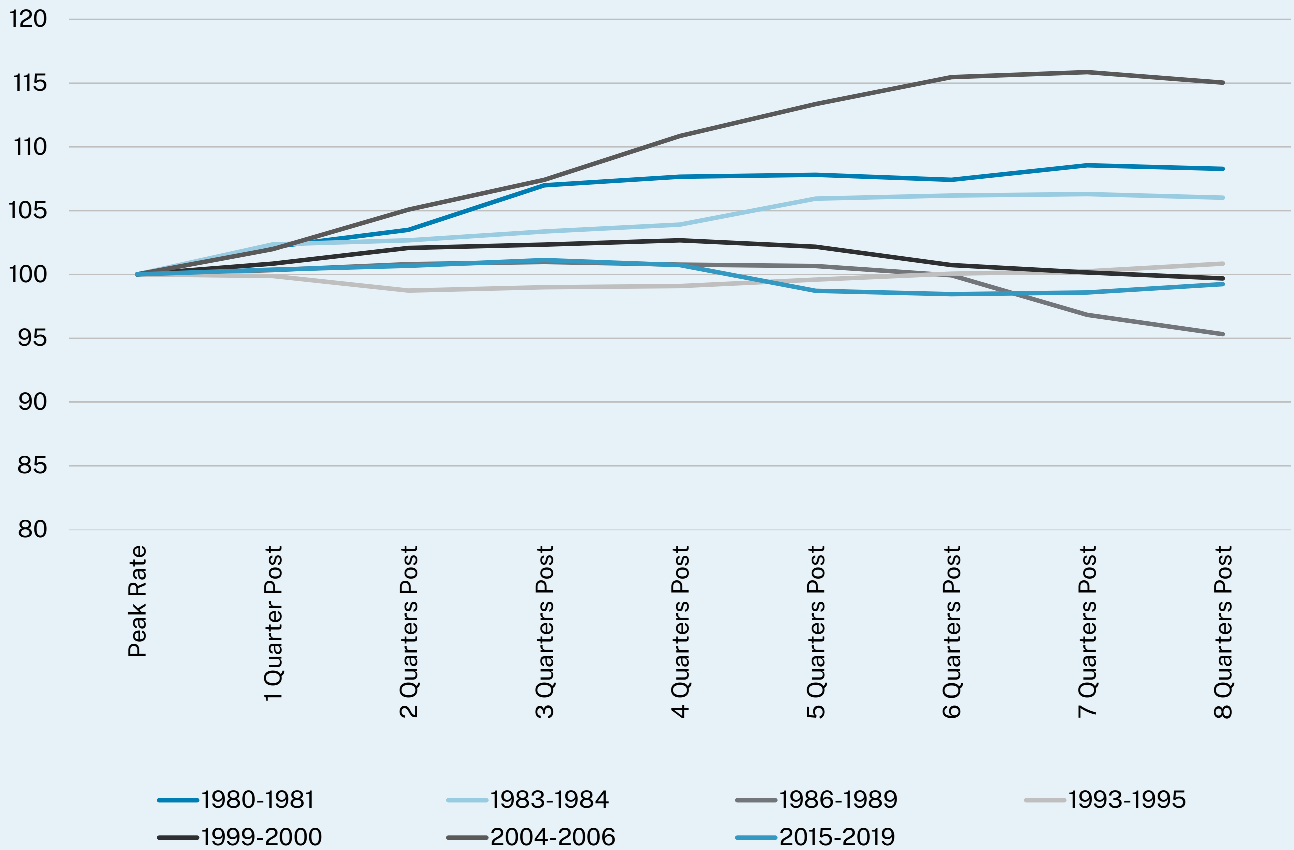
NPI Appreciation and Net Percentage of Domestic Banks Tightening Lending Standards, 1Q 2000 – 2Q 2023



Source: American Realty Advisors based on data from FRED St. Louis and NCREIF as of October 2023

FIGURE 3

NPI Appreciation Returns Indexed to the End of the Historical Rate Hike Cycles, 1980 – 2019



Source: American Realty Advisors based on data from Macrobond and NCREIF as of May 2023

The rising rate environment has spurred the tighter lending conditions, so rate trajectory (where rates go from here) and rate stability will be key to a resumption in lending and a return to positive real estate appreciation. Rising interest rates can increase default risks to banks (so they tighten their standards), creating asset-liability mismatches. When the cost of short-term borrowing goes up faster than the long end, this squeezes bank margins, making lending less profitable. All of this contributes to tightened lending.

If we are approaching the peak of the Fed Funds Rate hiking cycle, there is reason to believe liquidity will improve, which should boost values. Reaching peak rates should give real estate investors cause for optimism – in the last seven rate hike cycles, values were higher 86% of the time four quarters after reaching peak rates (Figure 3).

Guideposts

Though each capital markets cycle has its own unique set of circumstances, the general makings of a value recovery are identifiable to those investors who watch for them. A resumption of transaction activity driven by improved lending conditions fueled by greater stability in the rate and economic outlook should prove sufficient to reviving this critical component of private real estate's total returns.

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