Strategic Allocation - Real Estate and Interest Rates

Today, short-term interest rates continue to hover at historic lows. The U.S. Federal Reserve is likely to follow through on its promise to gradually raise rates, which has rightfully caused investors to be more concerned about the effects that higher interest rates will have on asset values such as commercial real estate. To help explain how one ought to expect real estate values to behave in a rising interest rate environment, we will first explain the concept of cap rates and the relationship of cap rates to interest rates.

Capitalization rates ("Cap rates") are simply the ratio of a property's net operating income (the rent) to its market value. Determining the value of an income generating property generally involves establishing a cap rate according to a comparable. Think of it like the inverse of the P/E multiple in equities. Cap rates put income in the numerator, and the price in the denominator. If the price of a property moves up, but the income it generates stays the same, the cap rate will fall meaning one is essentially paying more for each dollar of income generated. Price is generally determined by taking the income and dividing it by the cap rate. Therefore, how the cap rate evolves is a key determinant in value.

It likely seems obvious that real estate cap rates and interest rates should be related. The real estate industry is capital intensive and relies heavily on debt, so the cost of debt capital in particular will be important. One reason that many feel that interest rates will have a big impact on commercial real estate prices is that they actually do have an immediate impact on housing prices. Many home buyers are most concerned with monthly payments rather than the overall value of the house or condo. One would conclude that falling interest rates have offered real estate investors lower borrowing costs, which enabled them to use those savings to pay premiums for properties, driving down the cap rates.

Further, from an investor's perspective, real estate investments typically have bond-like qualities that would make their value sensitive to interest rate movements. But the relationship between interest rates and real estate values is much more complex. With a bond investment, a change in price will result in a change of yield. That is, when the price of the bond increases, the fixed yield income or effective interest that the investor receives will fall; the income is lower as a percentage of the price. One could conclude mathematically that higher interest rates decrease the return to bond investors. It is however only one determinant in the pricing of property.

While historical analysis tends to indicate there is a 1:2 relationship between cap rates and interest rates (holding all else constant, cap rates would increase by about 50 bps for every 100 bps in interest rates), factors such as supply and demand, inflation expectations, and GDP growth all can have a significant impact on pricing which makes it virtually impossible to isolate and gauge the impact of interest rates. That is, when the asset price of a property increases, cap rates can actually either move up or down, muddying the waters if you would.

Where it goes depends on the movements of each variable in the cap rate: the income the property generates (the rent) and the value of the property. Movements in one of the variables tend to dilute the movement of the other. The net effect could be an increase or decrease in the cap rate.

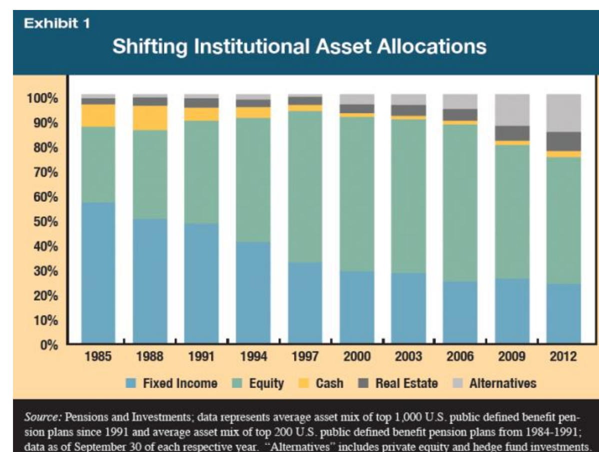
For example, when rents (income) are rising (falling), property values tend to increase (decrease) as well meaning both the numerator and denominator rise (fall) and the cap rate may not move. Low interest rates have certainly contributed to lowering cap rates as outlined above, however other factors such as falling property income due to vacancies, falling rent and other expenses have also contributed to low cap rates as the economy struggled to find its footing, particularly in industrial and office spaces. The stability of the property's income can dwarf or make mute the impact of changing interest rates depending on the individual property.

Although rising interest rates pose a risk of increasing the cost of capital and the changing relative attractiveness of other yielding asset classes could decrease demand for real estate, quantifying the effects of higher rates on property values is challenging. The reason for the interest rate change can also influence how it affects the value; rising interest rates are usually a result of a strengthening economy that pushes rents up and vacancy rates down improving investor's perceptions about future real estate cash flows. Another question is which interest rate is of the most significant to real estate; the yield curve is not flat and rarely do shifts occur in a parallel fashion. Just in this past year we experienced a 1% swing in 10-year rates while short-term rates did not move.

It ought to be noted here that the focus in making investment decisions ought not to weigh on short-term catalysts. Timing the market is not a science. It is impossible to get right time and time again. Investments are made for the long-term and long-term interest rates tend to hinge on inflation. Factors that could point to long-term inflation include those such as rising energy and commodity prices and growing trade and fiscal deficits. However, one could also point to long-term deflation in the developed world as we turn to an abundance of cheap goods and labour in places like China and India. If inflation remains subdued and the longer-term interest rates remain mostly stable, the impact of raising short-term rates on cap rates could be muted.

It is this uncertainty in both timing and outcome that have us preaching diversity in strategic allocation decision making. The unique characteristics of commercial real estate investing combining yield, stability, and growth undoubtedly give the asset class a role in enhancing the overall risk profile of a well-diversified portfolio as we move across market cycles.

At a time when central banks have pushed rates low for long, increasing the liability requirement and diminishing the funded status of many defined benefit plans, investors have begun looking beyond the scope of traditional asset classes for more attractive alternatives. According to Brookfield Asset Management and seen in Exhibit 1, institutional investors have seen the benefits of investing in real estate for some time and have been increasing their allocation over the last decade. This trend is likely to persist as stability and predictability continue to be top of mind.



Source: Pensions and Investments; data represents average asset mix of top 1,000 U.S. public defined benefit pension plans since 1991 and average asset mix of top 200 U.S. public defined benefit pension plans from 1984-1991; data as of September 30 of each respective year. "Alternatives" includes private equity and hedge fund investments.