

Multifamily cap rates in a rising interest rate environment

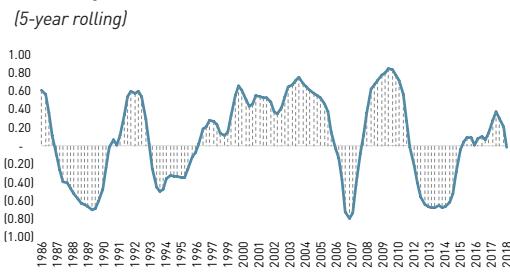
The recent rise in long term interest rates has led investors to question the impact of this trend on commercial real estate values.

Conventional wisdom states that interest rates are positively correlated to real estate cap rates. Therefore, when treasury yields rise, cap rates would be expected to rise in tandem, and vice versa. Given the collective value of commercial real estate in the US, estimated at \$9.9 trillion as of third quarter 2018 by CoStar Portfolio Strategy, it is worth taking a moment to review the available data to understand if this correlation can be demonstrated. Additionally, some basic calculations can help us understand the materiality of potential cap rate moves and the changes in NOI (Net Operating Income) required to offset potential falls in value from rising cap rates.

Multifamily cap rates and Treasury rates – a volatile relationship

For the following series of analyses, multifamily cap rates will be used, since it is one of the largest real estate asset classes in the US. Those who agree with the conventional wisdom that states that cap rates are positively correlated with interest rates (defined as the 10-year Treasury rate) are correct – 60% of the time. Those who think that multifamily cap rates are negatively correlated with interest rates, are correct – 40% of the time. The relationship between these two metrics varies greatly depending on the quarter or year in question, as demonstrated by figure 1 below.

Figure 1: US Multifamily Cap Rate and 10-Year Treasury Rate Correlation



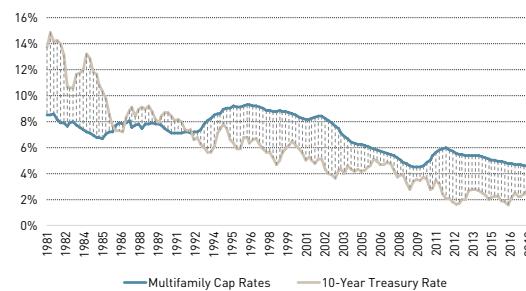
Source: FRED [Federal Reserve Bank of St. Louis], CoStar, as of November 2018

Interpreting economic and investment trends from a relatively small sample size (32 years of quarterly metrics) can be challenging due to the unique environment associated with each economic cycle. For example, the 1981-1992 period was mostly characterised by negative cap rate spreads (Treasury rates higher than cap rates). Additionally, the volatility between 2005-2012 coincided with the boom and bust surrounding the Global Financial Crisis, the worst recession since the Great Depression. Looking forward, the combination of strong economic growth and rising deficit spending creates a new economic backdrop from which to observe multifamily cap rate spreads.

Spreads – the risk appetite

Another relevant metric that receives consistent interest from US real estate investors is the spread between the 10-year Treasury rate and multifamily cap rates. This spread can be interpreted as the appetite for multifamily real estate. As one can see from figure 2 below, negative spreads gave way for a relatively consistent spread between the two rates. Between January 1993 and July 2018, the average spread was 2.46%, with a range between 0.72% (April 2007) and 4.06% (October 1998). The spread was 1.53% in July 2018.

Figure 2: US Multifamily Cap Rate Spread



Source: FRED [Federal Reserve Bank of St. Louis], CoStar, as of November 2018

A low spread implies that investors highly value the cash flows generated by this asset class. Multifamily real estate has the lowest cap rates among the major real estate asset classes in the US, which can be attributed to its stability throughout the cycles and the low capital expenditure requirements in addition to its inflation-protecting annual rent adjustments when compared to office or retail properties. Additionally, the average “Class A” multifamily property benefits from credit risk being spread across hundreds of tenants – typically affluent households, reducing reliance on a single tenant.

Downside estimates of potential increases in cap rates

If an investor believes that cap rates will rise over the coming years and wishes to allocate to multifamily real estate, then the question of rent growth becomes even more critical. According to an HQ Capital analysis of CoStar data comprising 2000-2017 multifamily rent growth across the 391 US markets covered by CoStar, compounded annual rent growth was positive on 93% of rolling five-year periods. Stated differently, if investors randomly chose markets (of 391 CoStar markets) and vintage years (from 2000) and held the properties for five years, investors could see higher property rents in 93% of cases at the end of these five-year periods.

However, since multifamily rents are generally inflationary over the long-term, this is hardly surprising. Furthermore, for investors who believe that cap rates will rise, the rent growth hurdle is higher. But how high?

According to HQ Capital analysis, in a “typical” acquisition assuming a 5.50% cap rate and a five-year hold, investors would require approximately 0.9% annual rent growth for five years to compensate for a 0.25% increase in cap rates during this hold period. Can investors reasonably assume that an average of 0.9% annual rent growth is achievable over a five-year hold period? According to analysis of CoStar data, 62% of five-year periods achieved at least this annual rate of rent growth.

The required rent growth to compensate for a 0.50% increase in cap rates would be annual rent increases of approximately 1.75% and only 29% of five-year periods hit this higher hurdle, illustrating the challenges investors face if they believe cap rates will rise.

What conclusion can be derived from this analysis? If investors believe that cap rates will increase, rent growth becomes even more critical for the preservation of capital and value creation. Using market data since 2000, it can be assumed that the majority of markets and time periods will not compensate investors for the value destruction from a 0.5% increase in cap rates. Given the ever-expanding variety of institutional-quality multifamily markets in the US, investors should partner with investment managers who have deep knowledge of the various economic cycles of each market. Additionally, while submarkets were not part of this analysis, they add an extra layer of complexity and opportunity for investors.

Key takeaway

“Risk comes from not knowing what you are doing.” - Warren Buffett

Cap rates can't be reliably predicted by moves in US Treasury rates. As cap rates rise, increasing rent growth is required to maintain the asset's value. Decisions on the timing of entry into and exits from multifamily markets are complex and uncertain, though we believe that they can be improved with experience.

In accordance with legendary investor Warren Buffett's definition of risk, HQ Capital believes our “circle of competence” involves the selection of markets, working with experienced local development partners and overseeing strict risk management protocols, all of which have been refined over a 29-year history of multifamily investments in the US.



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