

Episode 23

Commercial real estate: 5 for '22

We continue our outlooks for 2022 and talk commercial real estate markets with Kara O'Halloran, Director, Investment Research and Andrew Korz, Director, Investment Research.

Kara O'Halloran (00:06):

Welcome back to Fireside, a podcast from FS Investments. My name's Kara O'Halloran. I'm a Director on our Investment Research team here. And we are continuing on with our 2022 year ahead content. On today's episode, I'm excited to talk all things commercial real estate. Joining me is Andrew Korz, another Director on the team who is here to talk about his top five big ideas for 2022. Andrew, welcome.

Andrew Korz (00:32):

Thanks for having me, Kara.

Kara O'Halloran (00:34):

So, Andrew, in 30 seconds or less, catch me up what happened to commercial real estate in 2021?

Andrew Korz (00:39):

Sure. So, I think just like the broader economy, the commercial real estate market rebounded spectacularly in 2021, after, obviously, a significant downturn during the COVID pandemic in 2020. We saw record transaction volumes in 2021 for a full year. We saw a two decade high in property price growth, specifically apartment and industrial sectors were the key drivers of both of those areas of growth. So, I think as we head into 2022, it's a really interesting starting point. And I think there's some really interesting things for us to go through today.

Kara O'Halloran (01:20):

Awesome. Let's get into it then. I want to start at the macro level. Inflation was clearly a very hot topic this year. We're recording this before the latest CPI is released, but we are expecting another strong print and this inflation topic naturally brings up the fed. As of right now, markets are pricing in two to three rate hikes next year. I know this is something you are closely watching when it comes to commercial real estate, so talk to me about what you expect in 2022 when it comes to inflation and the fed.

Andrew Korz (01:50):

Sure. So, I think inflation just like it has been in the second half of 2021 is going to be the top macro topic, especially to start the year. And because of that, the discussion is underway around how do investors protect their portfolios against the potential for persistent, durable inflation. And traditionally, we've certainly seen real estate thought of as an inflation hedge for a portfolio. Now, investors haven't necessarily needed that type of hedge in a long time, but there's two reasons that we see real estate as a theoretical hedge. First, landlords are generally able to raise rents as inflation rises. When operating costs rise, when cost of financing rise, landlords are able to increase rents, which can offset those cost increases.

Andrew Korz (02:43):

And number two, as inflation goes up, the cost of constructing new buildings tends to go up, which disincentivizes new construction and increases the value of existing structures. So, that's why we see real estate as an inflation hedge for a portfolio. Now, the numbers, when we look back, certainly do support that. So, over time, we ran a regression. Fancy, I know.

Kara O'Halloran (03:06):

It's always great to talk about running regressions on podcasts.

Andrew Korz (03:10):

It's a very simple Excel function. So, we ran a regression controlling for recessionary periods and for real GDP. And what we found is for a given 1% increase in CPI inflation, real estate returns tend to go up by 0.93%. So, almost a one for one hedge. So, in theory, real estate is thought of as an inflation hedge, but the numbers actually back it up that, that is in fact the case. And from a qualitative perspective, when you think about the drivers of inflation next year. Tenant demand for apartment buildings, supply chain disruptions, those two areas really feed into the two biggest sectors that we've talked about in real estate this year, which are apartment and industrial, and should continue to drive demand for those two sectors next year.

Kara O'Halloran (03:56):

Okay. So, real estate, expecting to be a good inflation hedge next year. The data shown us that. The other big topic that we've been talking about is the fed. As I said, two to three rate hikes priced in next year. We just spoke with our chief economist, Flora Ram, and she's calling for two fed rate hikes. Going to be clearly another big topic of discussion in 2022. How does this impact commercial real estate?

Andrew Korz (04:19):

Yeah. So, policy is the other side of the inflation coin. The fed's not just going to let inflation run hot without trying to do something about it. As you said, the market's pricing in two to three rate hikes right now, we're probably on the lower end there, but there's a lot of uncertainty there. I think the common misconception that I imagine Laura spoke to you about as well, is that fed rate hikes lead to higher long term rates, and that higher long term rates lead to rising cap rates. Historically, those relationships are fairly tenuous. The stronger relationship there is really with real interest rates. So, historically, when we've seen the fed begin a tightening cycle, that has generally been when real interest rates tend to trough.

Andrew Korz (05:03):

Now, right now we know real interest rates are deeply negative. They're somewhere around negative 1.2% at the 10 year point. So, I think going into next year, there is risk that the fed begins a tightening cycle, that real interest rates could move higher. Now, even a 50 basis point move higher is fairly significant. We saw cap rates come down roughly 80 basis points in 2021, and that contributed to 15% price growth just from cap rate compression.

Andrew Korz (05:32):

If we were to see cap rates just go flat, like we did during the tightening cycle in the late 2010s, that could have a fairly significant impact on property price growth. And in fact, in 2022, we do see NOI growth or rent growth contributing much more meaningfully to overall price growth than it did in 2021.

Kara O'Halloran (05:57):

Okay. So, we've set up the macro story clear. There's a lot of uncertainty. We're going to closely be watching inflation in the fed and its impacts on real estate, as well as on the broader economy. One of the big trends that we've talked about when it comes to real estate and we've written about it as well, is this housing boom. I think everyone was talking about that. But also, this massive migration towards lower cost cities and that has fed through now to the commercial real estate markets. So, what are you seeing there?

Andrew Korz (06:24):

Yeah, absolutely. And we've talked about this previously with our housing note, shameless plug. There is this broad migration toward cheaper, less dense cities. We see it in the labor force statistics for different metro areas. We see it in surveys. This is clearly a trend that was accelerated by COVID. It was in place before COVID, but it's really been accelerated. And this sort of migration driven by this housing boom has fed through to the CRE market as well. So, we've seen 18% property price growth year over year in what we call non-major metros, versus just 10% in major metros.

Andrew Korz (07:08):

So, this is a fairly significant outperformance. So, it does call into question, can this continue? Our view is that it can. When you look at the drivers that have driven this outperformance of secondary cities, people having flexibility to work from where they want to, people want more space or buying second homes, businesses are diversifying their real estate footprint. All of these things are still in place. So, we look at next year, we really don't see a reason why non-major metros can't continue this outperformance.

Kara O'Halloran (07:40):

Yeah. I mean, I think a lot of the pandemic behaviors are becoming pretty sticky. So, talk to me about the office, obviously, a massive part of the commercial real estate discourse over the past two years. We just talked about people have moved. They can work remotely, but I also imagine eventually offices are going to start to move as well. So, what are you watching there?

Andrew Korz (08:02):

Yeah. And this dovetails nicely from the last point. I think 2022 is really going to be the year that the office sector begins to settle into its new normal. I think 2021 was Helter Skelter. Are people going to come back to the office? Are they not? Is there going to be a new COVID variant? I think we've gotten to the point where companies and employees have realized that we're probably never going back to the pre-COVID normal, and we're probably going to go into a new normal. Work from home's not going away. If we look at, for example, a Gallup survey of white color workers, more than two thirds of them are still working from home, at least some of the time. Now, less and less are working exclusively from home and more and more are working part-time from home and part-time in the office.

Andrew Korz (08:50):

But the trend remains that work from home, at least as an option for workers is not going away. Now, what does this mean? It means changing demand for office. Employees want to be more flexible and employers need to adapt their space to that. It also means that the supply side has had to adapt. Office construction spending is 30% below pre-COVID trend right now. So, you're going to see less spending on office construction as this trend continues to develop. So, I think 2022 is really going to be investors and employers navigating this new world and deciding how to react to employees' new demands for their position.

Kara O'Halloran (09:34):

All right, Andrew, I gave you 30 seconds when we started to talk about how we got here in 2021, and I'll give you another 30 seconds now, 2022, kind of put a bow on it.

Andrew Korz (09:43):

Yeah, sure. So, 2021 was a really strong year. I think we're in a new expansion and I think 2022 is going to be another really strong year. The economic backdrop is really solid. You do have the risk that rates could come up, which could pressure cap rates and valuations. In that case, we could look for hedges in shorter term, lower duration, CRE, CLOs, or floating rate loans, for example. But in general, the real estate market looks really strong. Rates are still low. Historically, again, the economy's strong. We're going to see a furthering of the reopen trade. So, I think 2022 is going to follow, 2021 is just a really strong year.

Kara O'Halloran (10:27):

Awesome. Well, Andrew, thank you so much for hopping on. You have published a chart book, your five big ideas for 2022. It is available along with all of the rest of our 2022 year ahead content on fsinvestments.com. Thanks for joining.

Andrew Korz (10:43):

Thank you, Kara.

Kara O'Halloran (10:50):

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