Episode 31

Research recap: Q2 2022 Commercial real estate outlook

The commercial real estate market enters Q2 with strong fundamentals, but they may be tested in the months ahead. We break down our CRE outlook.

Kara O'Halloran (00:05):

Welcome back to FireSide, a podcast from FS Investments. My name's Kara O'Halloran, and today we are continuing with our Q2 outlook content with an episode focused on commercial real estate. So, I'm excited to have Andrew Korz, another director on the team here to discuss all things CRE. Andrew, welcome. Thanks for joining.

Andrew Korz (00:23):

Yeah. Happy to be here.

Kara O'Halloran (00:25):

So, commercial real estate, like a lot of other asset classes started 2022 in a pretty strong position. Really good fundamentals, tailwinds from this strong expected economic growth. The market had just come off of a year of exceptional property price growth with record sale volumes. There were definitely headwinds in the form of inflation and the Feds tightening cycle. Some of the things that we've talked about at a macro level and the things that apply to other asset classes. But I think what would be helpful is if you just kind of catch us up. What happened in the first quarter? Where does CRE sit now?

Andrew Korz (00:58):

Sure. Yeah. I think when we think at the broadest level, what public markets are focused on right now is of course, as you said, inflation, it's the war in Ukraine. It's rising COVID cases in Asia. And there's a lot of mixed sentiment about the forward sort of outlook for the economy. But right now, sort of sitting here on what is it, April 12th, the US economy is really strong right now. And as we know, the commercial real estate market is an economically-sensitive one, generally speaking. Rent growth and fundamentals in commercial real estate are really strong. The past few quarters we've talked about inflation a lot. We've talked about sort of the inflation hedging nature of real estate in previous episodes. And over the past few quarters, we've really seen that come to fruition.

Andrew Korz (01:51):

If we just kind of tick down the different sectors in multifamily, you're seeing an incredible spike in demand, vacancy rates are below 6%, which is as low as we've been in multiple decades. We see from sources like Zillow that rents for new apartments are up 17% year-on-year. You look at industrial where the growth in e-commerce and in the goods trade is driving rent growth above 8% there. In retail and hotels, it's a little more of a cyclical story. Sort of the rebound from COVID is driving some strong rent growth there, but it's not as much of a secular story as it is sort of in apartment and industrial. And then in office, of course, it's highly dependent on the region and on this specific asset that we're talking about, but at the highest level, again, I think the U.S. economy, the U.S. consumer is in a really good place right now. And as a result, commercial real estate fundamentals are really strong.

Kara O'Halloran (02:55):

Great. So, I want to dive into one of the almost headwinds that we did talk about, and that is cap rates. So, obviously, cap rates are a very important part of any serious discussion, but I think it's something that we're going to be talking about a lot this year, and we'll get to why that is and dive more into that. But first, I think it'd be helpful if you just walk us through the history between cap rates and interest rates and why we're going to be talking about cap rates so much and why they're such an important part of the conversation this year.

Andrew Korz (03:26):

Sure. So, cap rates, just define them up top, cap rates are sort of the yield that a property owner gets on a property. It's simply the net operating income. So, the rental income net of expenses divided by the value of the property. It's essentially if I'm going to buy a property, what can I expect every year that property to yield in rental income. And historically, there's been a bit of a mixed relationship between interest rates, thinking of treasury yields here, and cap rates. It's complicated. It's certainly not linear. And I think from the broadest macro perspective, both have been driven down over the decades by the same things that we've talked about over and over again. It's aging demographics. It's the savings glut. It's decline in productivity and GDP growth.

Andrew Korz (04:22):

All of these have driven interest rates down and have also kind of driven cap rates down on a secular basis. On a shorter-term scale. It's a lot more muddy. And the way that we prefer to look at it is that as an inflation hedge, commercial real estate cap rates tend to react a lot more to changes in real interest rates. So, for example, if you sort of see inflation expectations pushing nominal interest rates up, that's not necessarily going to push up cap rates because, as we're seeing right now, higher inflation tends to be compensated for by higher rent growth. But when we see real interest rates go up, which we tend to see sort of in periods when, for example, the Fed is hiking their policy rate. That has tended to flow through to cap rates at not one-to-one clip, certainly, but certainly at a more statistically significant clip. That's sort of how I prefer to look at that relationship.

Kara O'Halloran (05:33):

That's helpful. And I think one thing to just reiterate is that we had these, like we had bond yields declining for the better part of 40 years, and that was really just this epic bond or bond bull market. Goodness, let's say that five times fast. We had that in cap rates as well, that that decline in cap rates has really contributed to this price growth that we've seen. Okay. So, let's talk about, you brought up the Feds hiking cycle. And so we're sitting here. It's April 12th. The Fed has hiked once. We expect many more hikes. I think everyone's consensus is for a 50-basis point hike next meeting. I was reading your outlook and I thought it was super interesting, some of the points that you talking about the last two Fed rate hike cycles.

Kara O'Halloran (06:20):

I think we're all trying to navigate what's going to be the same this cycle and what's going to be different. So, let's talk about the last two. The cycle that started in 2004, the Fed hiked I think 17 consecutive meetings, and we saw mortgage rates rise alongside the Fed hiking, but cap rates declined. And the next cycle, which started in 2016, we saw mortgage rates rise, but we saw cap rates stay the same. So, I'm curious what drove the differences, in your opinion, between those two cycles? Using history as a guide, do you think that this cycle will look more like one of those or the other, or like something completely different? So, a multi-part question there.

Andrew Korz (07:07):

Yeah, no, I think this is the crucial question for the market right now is what's going to happen to cap rates. And I think if you look back into the mid-2000s Fed hike cycle, which you set up the Fed hiked 17 straight meetings at 25 basis points per meeting. We saw mortgage rates rise, as you say. So, the cost of financing a property went up, but cap rates, which again is the property yield on property, declined. This relationship that we talk about between interest rates and cap rates certainly did not hold up in that period. And I think when you dig down into the nitty-gritty of what were the different market participants doing during this episode, what you start to see is that lenders were willing to loosen their underwriting standards to allow cap rates to come lower.

Andrew Korz (08:02):

So, if I'm a safe fund looking to buy a commercial real estate property and I'm in a competitive market, and I need to keep bidding these property prices higher in order to win a deal, so a lender needs to be willing to lend to me at this level. And as the rate on my mortgage goes up, my cost of servicing that debt goes up, which all else equal, is going to lower the return to the property owner. So, what can I do? I can accept a lower, which no property owner wants to do because they have target return rates that they want, or I can ask my lender to say, "Hey, I know you were going to lend to me $75 to my $25 of equity, are you willing to give me 80 bucks in debt? Are you willing to give me $85 in debt?"

Andrew Korz (08:57):

So, basically, these lenders were willing to put up more debt on a deal to make the economics work for the property acquirer. And what you saw was, as mortgage rates came up, the market stayed competitive. And really where this release valve was, if you will, was in debt-service coverage ratios. So, when these property owners bought these properties, they put on more debt, mortgage rates were up, and their ability to service that debt declined, of course. So, you saw valuations continue to go up, even as mortgage rates up. [crosstalk 00:09:38] We all know what happened in '07-'08.

Kara O'Halloran (09:40):

We all know what happened and how that ended.

Andrew Korz (09:41):

And fast forward to the next cycle, the 2010s where the Fed started hiking in earnest in late 2016, it was a completely different backdrop. Mortgage rates went up almost the same exact amount they went up in the 2000s, but cap rates were completely flat. They went from 6.5% in Q4 of '16 to 6.5% in Q4 of '18. And the difference is that lenders were not willing to lower their underwriting standards to finance these properties at higher and higher valuations.

Kara O'Halloran (10:16):

We learned our lesson a little bit.

Andrew Korz (10:17):

Yep. And again, the canary in a coal mine here is the debt-service coverage ratio. It went up over this period. Property owners' ability to service that debt went up. And to me, it all comes down to what our lenders are willing to put up with and not put up with.

Kara O'Halloran (10:34):

Yeah. So, where we at now in this cycle?

Andrew Korz (10:37):

My view is that the global financial crisis sort of changed the lending market on a durable basis.

Kara O'Halloran (10:46):

I hope so.

Andrew Korz (10:48):

Yeah.

Kara O'Halloran (10:48):

We all hope so.

Andrew Korz (10:51):

Yeah. So, if you look at right now, the leverage levels that lenders are lending at, if you look at debt-service coverage ratios, they are incredibly strong, much different than they were in the lead up to the global financial crisis. And we're not-

Kara O'Halloran (11:05):

We've had rock-bottom rates.

Andrew Korz (11:07):

Yeah. We'll see. As mortgage rates come up, it's going to test these lenders, it's going to test the market. I think we're going to see whether this new environment is going to change it all. But my expectation is that the regulatory reforms that have been put in place on lenders, as well as just the scarring from the '07, '08, '09 period, I don't think we're going to see anything like that.

Kara O'Halloran (11:36):

Okay. That's good.

Andrew Korz (11:39):

Which to put a bow on that, that means that property acquirers may need to accept that cap rates may not fall significantly from here. Because lenders are going to say, "Oh, no, I'm not allowing my standards to be lowered." You're going to need to accept lower property price appreciation to compensate for those higher mortgage rates.

Kara O'Halloran (12:04):

Okay. So, that brings up another question. I almost think about it similarly to equity markets where we've seen multiple contraction already and really expect earnings to be driving the majority of equity markets going forward in this Fed hiking cycle. I know you've done a lot of great work on that. So, it seems similar here. If we don't expect cap rate compression to be driving returns, we're going to be more income-focused. It's just the math of that equation. And so then I have to believe that there's maybe heightened dispersion and sectors that you're looking at more closely. So, what are you looking at on a sector basis or more dispersion, less dispersion, what's going on there?

Andrew Korz (12:50):

Yeah. No, that's a perfect setup because as you say, there's really only two sources of return in owning a property. It's the rental income and it's the price appreciation, which comes partially from cap rate movements. So, in terms of dispersion, it's been massive since the onset of COVID, but really the dispersion has been between good sectors and good metro areas versus incredible sectors and incredible metro areas. I think as this cycle continues on and as interest rates continue to rise, as the Fed continues to hike, we're going to go more towards a backdrop where you have really good to great sectors, really good to great metro areas and regions to some not so of great areas and some not so great properties and sectors. So, I think that's an important distinction in terms of... Dispersion is already super wide. It's probably going to stay super wide, but I think we're sort of shifting the goalpost a bit as interest...

Andrew Korz (13:51):

Look, I think at every asset class, higher interest rates make investors more discerning. You take away that valuation lever that investors can pull for return, and it really comes down to fundamentals. As you talked about, we're seeing in the equity market right now. So, I think as we kind of come into the next year or so, investors are going to really hone in on what are the fundamentals not only of this sector, not only of a certain city or metro area, but of specific properties of specific submarkets. And, obviously, that's not something we can go all into here. We don't have the time, sadly.

Kara O'Halloran (14:31):

I know you would like to, if I would allow you. Maybe we'll do a long-form episode.

Andrew Korz (14:36):

Yeah, yeah, yeah.

Kara O'Halloran (14:38):

Another time.

Andrew Korz (14:38):

I'll just read out my entire [crosstalk 00:14:40]

Kara O'Halloran (14:39):

Don't hang up, readers or listeners.

Andrew Korz (14:42):

But no, I think sometimes people try to overcomplicate this, but I think when the backdrop for interest rates and for the Fed is the way it is, investors start to look for the areas where fundamentals are the best. So, you're looking at industrial. You're looking at apartment. You're looking at areas of office and retail where the demographics are strong. And in terms of regionally, you're looking at places like the Sunbelt, places where the migration trends are strong. Places where wealthy people who can now work from home are migrating there and bringing their big salaries. So, I think at its simplest level, if cap rates are flat, again, the lever you can pull returns is income growth.

Kara O'Halloran (15:33):

So, what about on a capital structure basis, if you are expecting the possibility of less property price appreciation, do you move up the capital structure or do... Real estate's a great inflation hedge. So you have that. There's kind of this battle. Do you have any thoughts there?

Andrew Korz (15:53):

Over the past year, property prices were up 20%. That is almost unheard of in the history of the market. That's an incredible performance. This is a period where you've had rock-bottom interest rates combined with incredibly strong acceleration in fundamentals. You cannot think of a better backdrop for real estate. We're going into a different regime right now. And I think we have to acknowledge that while fundamentals are really strong, the risk-return dynamic is changing between owning the property via equity or lending to the property. So, as we go along in this cycle, you have to consider, "Okay, what's the risk? Certainly, who takes the first loss on any property? It's the equity holder. And you're compensated for that generally with a higher return. As we go forward and expected return on equities gets a little bit less certain, if cap rates, again, sort of go flat as we start to expect, the calculus changes. And I think debt as a... It has exposure to the inflation-hedging nature of real estate, but you're higher in the capital structure and it's certainly more stable.

Andrew Korz (17:09):

So, I think as we go forward, later into a cycle, debt starts to look a lot more appealing in relation to owning. But again, I think it's important to recognize that equity isn't certainty. Real estate equity is not a homogenous asset class. Real estate is incredibly heterogeneous. It really depends on what you own and where you own it. But I think the case for debt is certainly getting very strong.

Kara O'Halloran (17:37):

All right. So, Andrew, we just focused on commercial real estate, but I can't have you on to not ask a housing market question just because of how big of a topic of conversation it's been. So, I looked before we walked into this room, and 30-year mortgage rates were over 5%, like 5.1-5.2%. Anecdotally, I think people are hearing maybe the market's slowing a bit or it's kind of we're in that last push right now of people have their rates locked for 90 days or whatever. So, they're just buying something while they can, what is your outlook on housing market?

Andrew Korz (18:17):

That's a tough one.

Kara O'Halloran (18:19):

I know, I know. I don't think I prepped you for this one.

Andrew Korz (18:22):

Yeah. So, I mean-

Kara O'Halloran (18:25):

This is actually, I'm just curious.

Andrew Korz (18:27):

I think everybody kind of has a take on the housing market right now. It's kind of been the perfect microcosm for the COVID economy where you have incredible demand. You have labor shortages of construction. You have shortages of supply of existing homes and of materials that are needed for new construction. So, it's just been sort of this Wild West. I think you purchased a home over the past year or two. You can speak firsthand how crazy the market's been.

Kara O'Halloran (18:56):

And I was complaining about my rate then, and I look where I am now and I'm like, "Oh, okay. [inaudible 00:19:02]"

Andrew Korz (19:02):

I think that worked out for you okay.

Kara O'Halloran (19:04):

Yeah, looking at a long-range chart, I'll be pretty happy.

Andrew Korz (19:07):

Absolutely. So, as you pointed out, 30-year mortgage rates over 5%, and it's not just the level, it's how quickly it's gone to 5%.

Kara O'Halloran (19:19):

Insane, insane.

Andrew Korz (19:19):

Yeah. So, I think we're still sort of sorting out what this means. If you look at just very simply what it means for the mortgage rate on the average house, the mortgage payment's gone up over 30% in the past year. The hit to affordability is real and you can't ignore it.

Kara O'Halloran (19:40):

But on the other side of the coin, we're seeing really high rent inflation. So, at least you're locking in a mortgage rate and you're not going to see a 10% rent increases every year. And not that that's what I'm calling for, but, I think that's been a different mental calculus that we've had to do because, maybe you were seeing 2% rent increases before, but now they're really massive rent increases. Obviously a lot goes into a decision whether to buy or rent a home, but that's certainly something you have to think about now more than you did.

Andrew Korz (20:11):

You're exactly right. I think we're all kind of trained to given relatively weak housing demand over the past decade or two, we're trained to think about it as renting versus owning and what are the economics of apartments versus houses. And right now, it's both. And the reason it's both is you have this secular boom in demand for shelter. You think about the millennials who were delayed in their home buying, following the global financial crisis because they came into the labor market at exactly the wrong time. So, they were delayed in buying their first house. They're now coming to the market and just driving this boom in demand for starter homes. On the higher end of the housing market, you have the boomers who have all this wealth and are looking to buy second homes and potentially downsize. They're active in the market.

Andrew Korz (21:03):

And then you have people moving out of their parents' houses after COVID looking for apartments in the city. And then you wrap in the whole remote work thing. And People want more space. They want an extra bedroom as a home office. So, the demand for square footage has gone up. So, all of these things come in and what it means is that it's not housing or apartments. It's both. It's being squeezed from everywhere. And you're seeing, again, Zillow, 17% year-on-year rent inflation. Housing prices are up 20% even as mortgage rates are coming up. So, the demand for shelter is really high. Look, when the Fed is raising rates, housing is the first place that people look as where's this going to slow the economy down. [crosstalk 00:21:51].

Kara O'Halloran (21:51):

It's the most interest-rate sensitive sector.

Andrew Korz (21:52):

It's the most interest rate sensitive sector. And there's reason to believe that is… Mortgage applications are falling. Existing home sales are starting to fall from incredible levels, but supply on the market, there's still no supply on the market. I think it will be interest-rate sensitive to a certain extent, but as we go forward, I'm not sure the market's going to roll over. There's just this massive demand out there. And everybody wants a house, and everyone wants more space. And then the other thing just to finish this off is the supply side where we underbuilt homes for 15 years. There just aren't enough homes out there. And we can't just go put up homes now-

Kara O'Halloran (22:31):

Especially not with our supply chains.

Andrew Korz (22:34):

Exactly. So, I think the market's in a really interesting area. And affordability's gotten pretty bad, but again, what's your alternative? Go rent an apartment and pray to God that rents don't go up to 8% a year? I mean, that's the other option.

Kara O'Halloran (22:52):

Oh, I want to do a whole episode on this. I could keep going, but I will cut us off there. Andrew, thank you so much. I really enjoyed this. I thought it was a fascinating conversation. But, yeah, I think we're going to have to do a deep dive. It's a must. So, we'll have you back on soon.

Andrew Korz (23:08):

The data's going to be very interesting for sure.

Kara O'Halloran (23:10):

Well, we're not going to do a data dump on a podcast, but-

Andrew Korz (23:13):

Please?

Kara O'Halloran (23:14):

We'll get you in to summarize it for us.

Andrew Korz (23:15):

Sounds good. Sounds good to me.

Kara O'Halloran (23:16):

All right. Thanks so much, Andrew.

Andrew Korz (23:18):

All right. Thanks, Kara.