Episode 41

Q3 2022 CRE outlook: Mean reversion, or something more?

As a slowing economy looms, our real estate experts outline what they're watching across each of the key sectors.

[00:00:00] Kara O'Halloran:
Welcome back to FireSide, a podcast from FS Investments. My name is Kara O'Halloran. I'm a Director on the Investment Research team here. On today's episode, we are going to take a tour of commercial real estate markets, specifically where CRE fundamentals sit now, what rising financing costs could mean for debt versus equity investors, and what a slowing economy means for the asset class.

[00:00:22] Kara O'Halloran:
So to discuss all of this, I am pleased to welcome my colleague, Andrew Korz. Andrew, thanks for being here.

[00:00:27] Andrew Korz:
Yeah. Thanks for having me Kara.

[00:00:28] Kara O'Halloran:
Yeah, sure thing. So last we talked a few months ago, we went through the strong fundamentals that the commercial real estate market had really after a record 2021. But we also discussed some of the headwinds that the asset class faced, mainly in the form of the potential for rising cap rates given the Fed's tightening cycle and some of the other kind of more macro topics that we discuss a lot on this podcast.

[00:00:50] Kara O'Halloran:
So I want to today get an update on some of those and then talk about where we may be headed for the next few months. Sound good?

[00:00:57] Andrew Korz:
Sounds good.

[00:00:57] Kara O'Halloran:
All right. Let's dive in. So CRE has, and rightfully so, a reputation as an inflation hedge, right? Which is particularly attractive given the levels of inflation that we've seen this year. Or I should say it historically has been a strong inflation hedge. So now that we've had about a year, or a year and a half of these inflationary pressures, we've had some time to assess whether that holds true this cycle. Right? So has it?

[00:01:24] Andrew Korz:
Yeah, no, I think that's, inflation is still top of everybody's mind, I think.

[00:01:27] Kara O'Halloran:
Totally. Yeah.

[00:01:52] Andrew Korz:
When we look back to the beginning of this inflation episode, which really if you look at CPI data, really started in March of 2021, where you had a combination of the last big piece of fiscal stimulus that came in late January of 2021. You had the reopening economy with the vaccine and you had this supply chain wall, where we really were unable to figure out how to expand capacity. So you had these three things coming together to form a perfect storm. And the question at that point for investors became "how do I position my portfolios to reduce my exposure to inflation and increase my exposure to asset classes that can actually utilize that inflation to boost their income generation?"

[00:02:13] Andrew Korz:
And the first thing that generally comes up is real assets, including real estate. But the reality is like, we haven't had an inflationary episode in a very long time as we've talked about. So we talk about real estate as an inflation hedge and certainly there's some good data back in the seventies and the eighties, but really it hasn't been tested in a very long time. So as you said, we've had about 15 or 16 months now since the start of this inflationary episode. And if we look across the market, most sectors have seen rent that has outpaced even the pace of inflation, which has been six, seven, eight percent for much of the last year and a half. Leading the charge sort of is multifamily, which has seen rent growth of north of 15%, which is massive.

[00:02:54] Andrew Korz:
But if you really think about it from a fundamental perspective, where has the, where's the demand been coming from? Right. It's been going to multifamily and housing because people have been moving out of their parents' homes. People have been shut out of the housing market and they've had to go rent an apartment so they can see rates there are incredibly low. It's gone to hotel because people want to travel again. It's gone to industrial because people have been buying durable goods, like appliances and furniture to furnish their new homes. So these parts of the real estate market have really been core to where that jump in demand has been going. So as an investor, you've really gotten to get exposure directly to where those inflationary forces are coming from. And that's really, exactly what we were hoping the market would do and the data so far is bearing that out.

[00:03:41] Kara O'Halloran
So the other big topic of conversation, other than inflation, has been growth. Right. So I think it's, and last we talked, I think the last time we did one of these outlook episodes was April and we had, we weren't really super concerned about illumining recession at that point. I think it was really in May when those recession fears really came to the forefront. Commercial real estate is a very economically sensitive asset class. You said fundamentals remain really strong. We've seen really strong rent growth. We've also started to see some moderation in price growth and in transaction volumes recently. Granted, they're moderating off of really, very high levels, but I think it still begs the question, is this just a mean reversion, or this is actually the title of your outlook, which I love. Is it a mean reversion or is it something more? Andrew, are you seeing any signs right now that this is a symptom of a broader economic slowdown?

[00:04:33] Andrew Korz:
Yeah, I think that's the operative question across a lot of asset markets right now, whether it's equities, whether it's housing, and certainly commercial real estate.

[00:04:40] Andrew Korz:
Is this something where it's just the market coming back to earth or, are we really going to something more challenging here? And there's a lot of things that go into that. I'm not going to try to answer that, for certain right now, I'm not probably in a position to make that forecast, but look there, there's no doubt that commercial real estate is an economically sensitive asset class, rents tend to decline at least a little bit, in a recession, depending on the depth of a recession, it could be more or less depending on the sector.

[00:05:06] Andrew Korz:
It could be more or less but rents tend to decline when the economy, is slower and they tend to go up when the economy is growing from a very basic level, that's how fundamentals are impacted by the economy. and if we look at the economy and the outlook right now, our chief economist, Lara Rhame her view right now is that look the possibility of a recession the probability has risen fairly substantially, specifically for probably the first half of 2023, which it's something that all, asset classes have to grapple with right now. Right. And certainly, it's something that, that real estate investors should be thinking about very hard that said I would, even in their case of a recession, I would offer two caveats.

[00:05:48] Andrew Korz:
The first being that we all have recency bias in investing and it's important to remember that the last two recessions have been really extraordinary, right? So you had the COVID crisis where it was really short, but [00:06:00] really sharp recession, right? Where demand evaporated. We shut down the economy. it was really an existential moment, not just for the economy, but specifically for real estate, because it is an inherently proximity driven physical, market. Right. And when you shut down the economy, nobody's going to retail stores, nobody's going to hotels. Nobody's going to offices.

[00:06:22] Kara O'Halloran:
Yeah. We completely changed the way that we live our lives.

[00:06:25] Andrew Korz:
Yeah. Yeah. and it was like...

[00:06:25] Kara O'Halloran:
...places that we lived our lives.

[00:06:27] Andrew Korz:
Yeah. and it was existential because you had concerns about, a wave of borrowers defaulting on their debt. Eventually we did have fiscal stimulus. We had the paycheck protection program. We had the main street lending program from the fed. They came in. they helped small businesses continue to pay their rents.

[00:06:41] Kara O'Halloran:
Yeah. And quickly. But I remember like the depth of, probably March 18th.

[00:06:46] Andrew Korz:
Yeah.

[00:06:46] Kara O'Halloran:
Before the Fed, around then it was terrifying. We didn't know.

[00:06:49] Andrew Korz:
Yeah.

[00:06:49] Kara O'Halloran:
We were all locked in our house. I had no idea that any of this was going to happen.

[00:06:52] Andrew Korz:
It was, and we found a way out of it. but it was a really existential moment.

[00:06:55] Andrew Korz:
And I think it probably overrates. The, the economic impact to fundamentals in a more normal recession. Right. And then you think about the recession prior to that, which was the global financial crisis, which was a recession wrapped inside of a financial crisis, right. where you had, this sort of contagion within the lending market, where, you had borrowers defaulting on their loans and banks and other lenders, had to write those loans off as losses. they pulled back from offering more financing, which sort of started this vicious cycle, which ultimately led to it really painful, prolonged draw down in property prices. The only other time we've seen that really was in the early nineties with the recession in 91 and the aftermath of the SNL crisis, where you had a bunch of banks that, that had failed. Other than that, whether you talk about the early 2000s recession, the ones in the eighties, you didn't have this type of really painful draw down in property prices.

[00:07:50] Andrew Korz:
So when we look at a recession, look like it's not good, but certainly the last two are extraordinary and we wouldn't expect that those impacts to necessarily be the [00:08:00] case in a gardened variety recession, if you will. And then the second caveat I would offer is just, this is a really heterogeneous asset class. Some areas are more cyclical, some areas are more defensive. You think multi, you think grocery anchored, retail, you think self storage, these are more defensive parts of the asset class. so not every sector is necessarily gonna be impacted in the same way.

[00:08:21] Kara O'Halloran:
Yeah, I think that's the first caveat you offered is very important cause I think, 08 is still was a while ago, but it's still really fresh in our minds and it was such a real estate driven recession. It's so hard to, you can like overlook COVID in a sense, just not overlook it, if you're thinking about recessions, that was that was such a sudden, the economy just completely shut down.

[00:08:39] Kara O'Halloran:
So the one that we look at, even, just more recently is 08.

[00:08:42] Andrew Korz:
Yeah.

[00:08:42] Kara O'Halloran:
And so that's so fresh in our minds and it was such a real estate driven recession. So it's, and I know we've talked about this when we did some of our housing episodes where, we don't see this housing bubble, but also, I think it's important that, what you just said, we don't see prices necessarily fall, unless there's a credit crunch element to it.

[00:08:59] Andrew Korz:
That's exactly right. And like exactly to your point, the 08 crisis was a credit crisis.

[00:09:05] Kara O’Halloran:
Right.

[00:09:05] Andrew Korz:
That turned into a really deep recession. there are none of the excesses in lending markets now that there were then. so we really don't see the same type of, same type of weakness from lenders as we did then. And I think that is a positive, even going into a more questionable economic environment.

[00:09:23] Kara O'Halloran:
So, so started you brought up lenders. So let's talk about financing costs. And when we last spoke, the Fed, I think had only hiked once. now they've hiked 150 basis points and by the time this episode comes out, they'll have likely hiked.

[00:09:36] Kara O'Halloran:
We expect another 75 basis point hike, tomorrow actually so obviously the cost of financing is increasing significantly. And with that. Comes, the returns to equity start to decline. So it puts equity investors in a tough spot. so right now, what do you think the major considerations are between investing in debt versus equity at this point in the cycle?

[00:09:57] Andrew Korz:
Yeah, I think it's a really important point. [00:10:00] We think about the residential market, right? Where we've seen mortgage rates go from below 3%. a year and a half ago to close to six and now hovering in the mid 5% range, the same thing's happening in the commercial market. The data's not quite as available and it's a little, every sector's gonna have slightly different data, but mortgage rates have skyrocketed in the commercial mortgage market.

[00:10:21] Andrew Korz:
And you look back over the past two years, it's been an incredible time to be a property owner. Because you've had a property that is maybe still, yielding five to 6%, in terms of rental income to the property owner. And you've had incredibly low financing costs. So the property owner is basically just capturing that spread between the two.

[00:10:42] Andrew Korz:
Right. And what that's done is it's brought in more and more demand because people say, oh,I'll happily buy a property at that. and capture that spread. And it's pushed up and pushed up property prices, to the point where we're now 20 plus percent year over year property price growth.

[00:10:56] Andrew Korz:
And that's just really been a feature, partially of really low financing costs. Now that they've come up more than 200 basis points. In some cases, it, it totally, repositions and creates a new equilibrium for the market. In, in, in my mind, it makes no sense economically for somebody to buy a property, finance it. at a 5.5% mortgage rate for a property that only yields 5%

[00:11:22] Andrew Korz:
it just doesn't make any sense. So really what's gonna have to happen in my view is that cap rates are gonna have to,start to rise in some cases, especially as we enter more questionable economic, outlooks here.

[00:11:35] Andrew Korz:
You're going to have to see valuations reset a bit, assuming financing costs stay where they are. but assuming they do, you're gonna have to see valuations start to, correct a bit. and what that means is that the property price appreciation tailwind that equity investors have had over the past couple years is not gonna be nearly as strong in our view over the next six to 12 months.

[00:11:57] Andrew Korz:
And in this type of environment where fundamentals are still strong, but financing costs have gone up really in our view, you want to be, higher in the capital stack. And first in line to capture that income, we think lenders are in, in a good. Position to, to capture a bigger part of that income pie, if you will. So I just think the dynamics have been totally changed by the cost of financing increase. and as we enter this later cycle environment and you wanna get a little more defensive, it's probably a good idea to go up in capital structure and debt offers you, an opportunity to do that.

[00:12:31] Kara O'Halloran:
Yeah. if your investment income or your income stream, your return stream, I should say from a real estate investment is income and, price gains. If those price gains are going to dissipate a little bit, you might as well, get higher in the capital structure and get a little more support.

[00:12:46] Andrew Korz:
And interest rates have gone up, which means lenders can generate more income. It's kind of that simple. Right?

[00:12:56] Kara O'Halloran:
Okay. So I wanted, wrap up with little, a little lightning round, if you will, rapid fire. something I like about doing these, sector-focused or asset class focused episodes is we get to we, yes. We talked a lot about the macro forces impacting the market, but I want to get a little deeper and I want to talk about some of the sectors, especially as we get later cycle, as interest rates start to rise just across markets, you need to be more discerning and especially in CRE, which is a very heterogeneous asset class.

[00:13:24] Kara O'Halloran:
So let's do a little around the sectors in let's call it, see if we can stick to three minutes.

[00:13:31] Andrew Korz:
All right.

[00:13:31] Kara O'Halloran:
Can we do it?

[00:13:32] Andrew Korz:
I, I will do my best.

[00:13:33] Kara O'Halloran:
I know you will. I, I'll give you a little leeway too. We have some time.

[00:13:36] Andrew Korz:
I appreciate it.

[00:13:36] Kara O'Halloran:
All right. So we'll do the five main sectors.

[00:13:38] Andrew Korz:
Sure.

[00:13:38] Kara O'Halloran:
So let's start with some of our pandemic darlings, if you will. Let's do multifamily and industrial.

[00:13:45] Andrew Korz:
Sure. So multifamily rent growth has been incredibly strong, as I mentioned over 15% year over year, which is completely unheard of. They can see rates are at all-time lows part of this is because we've started a lot of construction projects and we haven't finished them. And that's driven some of this rent growth. So as we get more supply online, I would expect rent growth starts to moderate, which actually, I would say, could be a positive for the economy because it's such a driver of inflation right now. if we can get that down a bit, it might actually be good for the economy and thus for multifamily demand.

[00:14:13] Kara O'Halloran:
Yeah.

[00:14:13] Andrew Korz:
So look, demand's still really strong.

[00:14:15] Kara O'Halloran:
Okay. How about, industrial? I know we saw some Amazon headlines.

[00:14:18] Andrew Korz:
Yeah.

[00:14:18] Kara O'Halloran:
That maybe they. Over overdone, the warehouse thing. how's the rest of the sector look?

[00:14:23] Andrew Korz:
Yeah. So when that happened, the public industrial rates, stock prices all plummeted.

[00:14:27] Kara O'Halloran:
Totally.

[00:14:27] Andrew Korz:
It seemed like that was more of a one off to Amazon who just invested a bit too much. vacancy rates are still at all-time lows, supply and demand still, getting a little more imbalance, but demand is still incredibly strong. E-commerce is a secular force. we actually see de-globalization as something that's gonna drive, increased demand as well as firms choose to hold more inventory. They're gonna need more warehouse capacity. so yeah, I would say it's not as crazy as it was maybe a year ago, but it's still in an incredibly high demand sector.

[00:14:55] Kara O'Halloran:
All right. How about, hotel?

[00:14:56] Andrew Korz:
So hotel fundamentals are actually really strong here. [00:15:00] occupancy rates are above pre COVID levels. of course the outlook for the consumer is important. Consumer confidence is really low right now, but people are still traveling. People still wanna engage in some of the activities they were unable to do, during the pandemic. So the leisure part of the hotel market is still booming. The business travel part is still a little bit questionable, but all in all the market is, fundamentals look pretty strong.

[00:15:23] Kara O'Halloran:
Okay. So speaking of business, let's hit office.

[00:15:26] Andrew Korz:
Yeah. it's challenging, right? Like it really depends on where you are both regionally and, in terms of the type of property that you're talking about, if you're talking about the south places in Texas, actually office demand is fine.

[00:15:37] Andrew Korz:
Places like San Francisco, not so fine. and then of course, like newer amenity, rich offices, like we're lucky to have here at FS people wanna come into those, right. If they have the option, they'll come in through it, three, four days a week.

[00:15:48] Kara O'Halloran:
We're here.

[00:15:49] Andrew Korz:
Yeah. We're here. older offices. If people have the option, they're not, they're just not gonna go in because it's not particularly convenient. So it's a, it's really heterogeneous within that, a within that sector, right now, but overall, probably the most challenging, of the five major sectors right now.

[00:16:04] Kara O'Halloran:
Yeah. Do you feel like the longer we stay home, the harder it's gonna be? it has to be right the longer you stay home, it's...

[00:16:10] Andrew Korz:
Yeah...

[00:16:10] Kara O'Halloran:
...harder. It is to get back to work. I, yeah. I think it's, I think it's here to stay...

[00:16:13] Andrew Korz:
An objected motion will yeah. There's inertia here. Totally.

[00:16:16] Kara O'Halloran:
Yeah. okay. Last one, retail.

[00:16:19] Andrew Korz:
Yeah. So retail, I would say it's a bit of a bifurcated market. You have the cyclical up trend for places like malls, but look like malls are still really challenged from a secular standpoint and you have things like grocery anchored retail, which grocery is the one thing that e-commerce, hasn't quite figured out. Like we still all go to buy our groceries. Physically in, in store.

[00:16:40] Kara O'Halloran:
I ordered mine online yesterday.

[00:16:41] Andrew Korz: Y
eah. But it, you're different.

[00:16:43] Kara O'Halloran:
It was like the first time I had done that in months since the depth of the pandemic, I didn't have enough time.

[00:16:47] Andrew Korz:
People wanna see like they wanna see the, be the bell pepper they're buying exactly. Right.

[00:16:51] Kara O'Halloran:
I wanna I'm I don't trust anyone else with my produce.

[00:16:53] Andrew Korz:
Yeah, exactly. so that type of, of property, grocery anchor, shopping center, Is really defensive in nature. it's something that, as you go into an economic slowdown, it's a place you wanna be. So it's, it's still a tough market because eCommerce is taking share there.

[00:17:09] Andrew Korz: But, we do see opportunities there. Cool,

[00:17:11] Kara O'Halloran:
Andrew. I have to say my favorite thing about doing, these rapid fire rounds with you is that you still say the same amount of contact. You just talk really fast. Yes. So that was pretty impressive.

[00:17:20] Andrew Korz:
You didn't set the ground rules here.

[00:17:21] Kara O'Halloran:
All right. next time I'll set the ground rules.

[00:17:24] Andrew Korz:
I will...

[00:17:24] Kara O'Halloran:
I think before we walked in, I said two sentences.

[00:17:26] Andrew Korz:
I will find way I will find a way.

[00:17:29] Kara O'Halloran:
Oh, that was actually quite impressive. alright, so I think that's a good place to wrap it up. Andrew, thanks so much for being on and we'll have you back soon.

[00:17:37] Andrew Korz:
Awesome. This was fun. Thanks Kara.