# HOW **RISING INTEREST RATES** AFFECT REAL ESTATE

Bespoke Holdings CEO analyzes and predicts the impacts on commercial real estate.

by **Blair Eklund**

Over the past few weeks, the 10-year Treasury note has increased from 2.90 to 3.25%. It has had dramatic effects on the stock market. I've been thinking about rising interest rates for a while and how it will impact asset values, specifically commercial real estate. Please find a few supplemental articles on this subject after my analysis.

## Will Rising Interest Rates Affect The Price of Real Estate?

It depends. There will be an increase in cap rates (lower price relative to the income the property provides) and there should be an increase in net operating income (income the property produces). The major determining factor for real estate values in the next few years will be the supply of specific types of products (i.e. industrial, multi-family, retail, office & hospitality) and demand for each type.

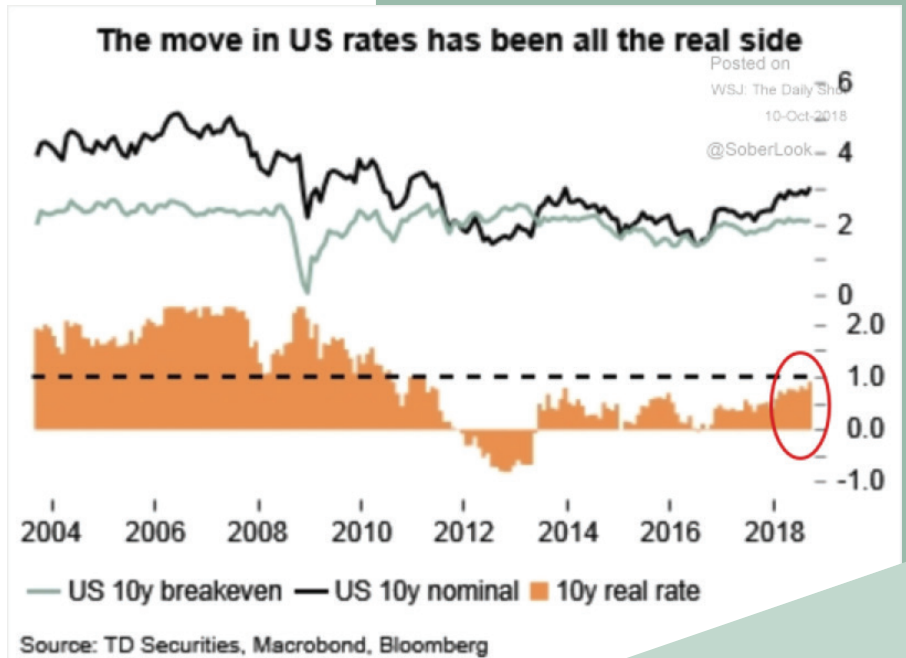
$$\text{Cap Rate} = \frac{\text{Net Operating Income (aka income after expenses)}}{\text{Purchase Price}}$$

In theory, if interest rates (specifically the 10-year yield) increase cap rates should adjust, as well. This doesn't always happen (See TH article pages 4 & 5). The spread between the 10-year yield and average cap rates has compressed (See TH article, page 6, figure 3) below the historical average of 320 (3.20%) basis points over the past year. The historical average today with the 10-year Treasury at 3.25 % would be 6.45 % (6.45 % = 3.25 % 10 yr. + 3.20 % historical premium). Long term rates are currently at the lowest levels in decades, while breaking out to the upside in yields. That said, cap rates should continue to maintain at the same premium or even increase its premium to bonds.

## Net Operating Income

In order to talk about Net Operating Income (NOI), let's first talk about where we are in the economic cycle and why interest rates are increasing. If this economic expansion lasts until July of 2019, we will officially have the longest expansion in U.S. history since the 1850s. But, as the saying goes "time doesn't kill expansions, greed does." The greed areas that seem to present po-

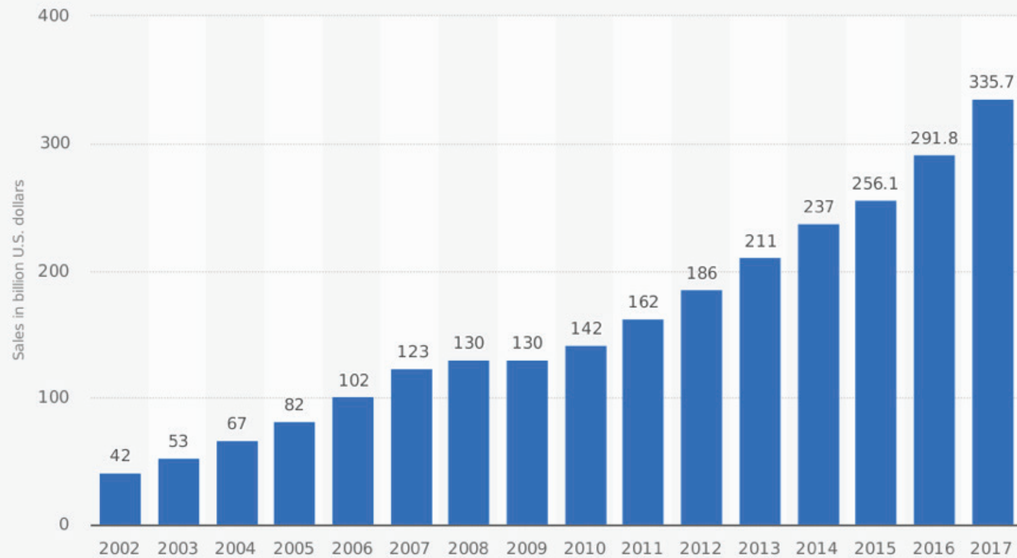
tential issues right now include emerging market debt denominated in U.S. dollars, U.S. corporate debt levels, high-yield debt levels relative to income and lastly, the U.S. Federal Debt. In other words, debt, debt, and debt.




On the other hand, all leading economic indicators I follow show positive trends. These include: stock revenue and income, the spread between the number of companies raising vs. lowering guidance, jobs reports, residential construction starts, ISM manufacturing & non-manufacturing, consumer confidence, a positive shaped yield curve, F-150 truck sales, US Citi Economic Surprise Index, and stock market valuations. Fortunately, the increase in the yield curve is attributed in real growth, not inflation [see chart].

Given interest rates are increasing, **rents should continue to increase supporting higher net operating income**. If you have a lease with 10 years remaining on it, the net operating income will not adjust fast enough unless there are significant inflation adjustments every year. Thus, properties with shorter term leases should be favored over longer leases unless there are significant inflation adjustments in the lease.

Whether rental increases will outpace the increase in cap rates, remains to be seen. Either way it will affect the value of properties. This will be dependent on each of the sub-sector classes of commercial real estate and there underlying economies. E-commerce will continue to negatively affect retail and positively affect industrial. This structural shift isn't new but its effects will continue to plague the market. As of 2Q 2018, only 9.6% of all retail transactions are e-commerce. Below is a chart showing the growth of desktop e-commerce sales. This does not include the largest category, mobile, in terms of percent increase.




I expect demand for industrial to continue to increase at the expense of retail. The other side of the equation—supply—is mostly local. Companies move but not in droves. To be successful in real estate, you have to have a firm understanding of the total supply today, what is under construction, and what could be under construction in the next 5 years in each market. The vacancy rate is a great barometer of overall health of the market.

Some risks to real estate valuations and the economy:

1. Cash equivalent rates rising to a level where investors feel they receive adequate income. This will be a significant paradigm shift from what the fed has done for the past decade. This could have a major effect on all risky asset classes, especially income producing asset classes such as equities, longer term bonds, high yield bonds, and real estate.
2. Long-term interest rates continue rising at a fast pace.
   - Variable rate debt resetting to higher rates.
   - New debt at a higher cost.
   - Home mortgage and car loan rates increasing rapidly and pricing out consumers.
3. The Dollar continues appreciating; foreign capital is one of the largest sources pouring into real estate.

## Summary

In summary, expect cap rates to continue to go up, lease rates to continue to go up, and industrial assets to continue to outperform retail. Late economic cycles tend to correspond with higher levels of inflation. **Real estate should provide a good hedge in this environment**.

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