The Theory of RELATIVITY

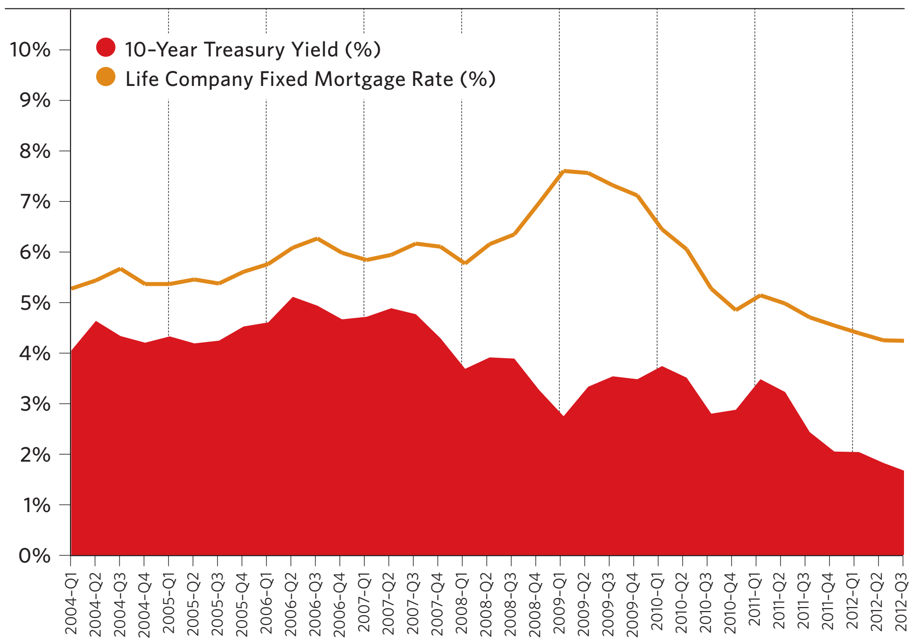
— by JAMIE WOODWELL —

COMMERCIAL REAL ESTATE MARKETS have picked up markedly from the lows of 2009 and 2010. They also remain cooler than during the heady days of 2006 and 2007. In relation to either of these periods, today's commercial real estate markets are hard to fathom. One of the difficulties is that assessments of today's market—mortgage rates, cap rates, property market conditions—are based more on relative measures than on absolutes. ¶ Looking ahead, how the markets act relative to their benchmarks will have a sizable impact on the future of commercial real estate—and commercial real estate finance.

Returns on commercial real estate are low on an absolute level but look good when compared to alternatives. It doesn't take a rocket scientist to figure out that relativity is the name of today's investment and lending game.

FIGURE 1

LIFE COMPANY FIXED MORTGAGE RATE



SOURCES: American Council of Life Insurers (ACLI) and Federal Reserve

Interest rates and mortgage rates

During the 1970s, the 10-year Treasury rate averaged 7.5 percent. During the 1980s, it averaged 10.6 percent (hitting a monthly average high of 15.3 percent in September 1981). During the 1990s, the average was 6.7 percent; during the 2000s, 4.5 percent. Thus far in the 2010s, the 10-year Treasury has averaged 2.7 percent. At the time of this writing in November 2012, it sits at 1.6 percent. It is fair to say that Treasury rates are extraordinarily low.

Commercial mortgage rates have followed suit. According to the American Council of Life Insurers (ACLI), Washington, D.C., the contract rate for life companies' commercial fixed-rate mortgages averaged 4.21 percent in the third quarter of 2012, down from the 4.67 percent average in the third quarter of 2011 (see Figure 1)—and down from a full 10 percent in 1990.

As of this writing, mortgage rates for commercial mortgage-backed securities (CMBS) loans are generally heard to be "in the low-4s and upper-3s"; for life company loans in the "low-4s and upper-3s"; for Fannie Mae and Freddie Mac loans "in the mid- to upper-3s"; and for Federal Housing Administration (FHA) loans "in the 2s."

Rates vary, and may get more aggressive for low-leverage and high-quality assets, and less aggressive for secondary markets and higher-leverage properties, but all in all, commercial mortgage rates are likely closer to zero than they have ever been.

A borrower taking out a $10 million mortgage with a 4.2 percent interest rate (the average for life company loans made during the second quarter of 2012) and a 20-year amortization will pay 8 percent less each month in principal and interest than he or she would with a 5.2 percent interest rate (the average for life company loans made during the first quarter of 2004). That means lower debt service, higher debt-service coverage ratios, easier financings and—all else being equal—more money each month in a property owner's pocket.

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Despite the low rates, spreads—the difference between the base Treasury rate and mortgage rates—are actually at relatively wide levels. The ACLI reported an average gross spread of 279 basis points during the third quarter of 2012. That's well down from the 500-plus spread at the height of the recession, but also more than double the 126-basis-point spread from the third quarter of 2006.

The same—generally—goes for CMBS. Relative to Treasury yields, spreads for the very safest CMBS bonds have returned to near their 2007 peak level, but the spreads on lower-rated bonds are wider.

According to New York–based JPMorgan Securities, the yield on 10-year new-issue senior AAA CMBS bonds (the safest in the capital stack) at the end of November 2012 was 96 basis points over Treasury rates (see Figure 2). That compares with a spread of 80 basis points at the end of March 2007, right around the peak of the market.

At the same time, the spread for new-issue BBB bonds sat at 441 basis points at the end of November 2012, compared with 183 basis points at the end of March 2007.

So, relative to Treasuries and compared with the peak of the market, new-issue CMBS—particularly lower-rated tranches—are providing a higher return. But on an absolute basis . . . not so much.

In March 2007, the 10-year Treasury was yielding 4.63 percent. Adding the 80-basis-point spread gave senior AAA bonds a yield of about 5.5 percent. With the 10-year Treasury down at 1.6 percent and the spread of 96 basis points in November 2012, AAA CMBS yields about 2.6 percent—or half of what one received at the market peak.

Today's commercial mortgage lenders and investors are choosing to put their money to work in loans and bonds that provide returns that are low on an absolute basis, but high relative to many other investment options.

Capitalization rates and property values

In an Oct. 1, 2012, speech to the Economic Club of Indiana, Federal Reserve Chairman Ben Bernanke noted, "Lower interest rates also put upward pressure on the prices of assets, such as stocks and homes, providing further impetus to household and business spending." If looking for evidence to support that statement, the chairman need look no further than the commercial real estate markets, but with a limit on how low in yield—and high in price—investors are willing to go.

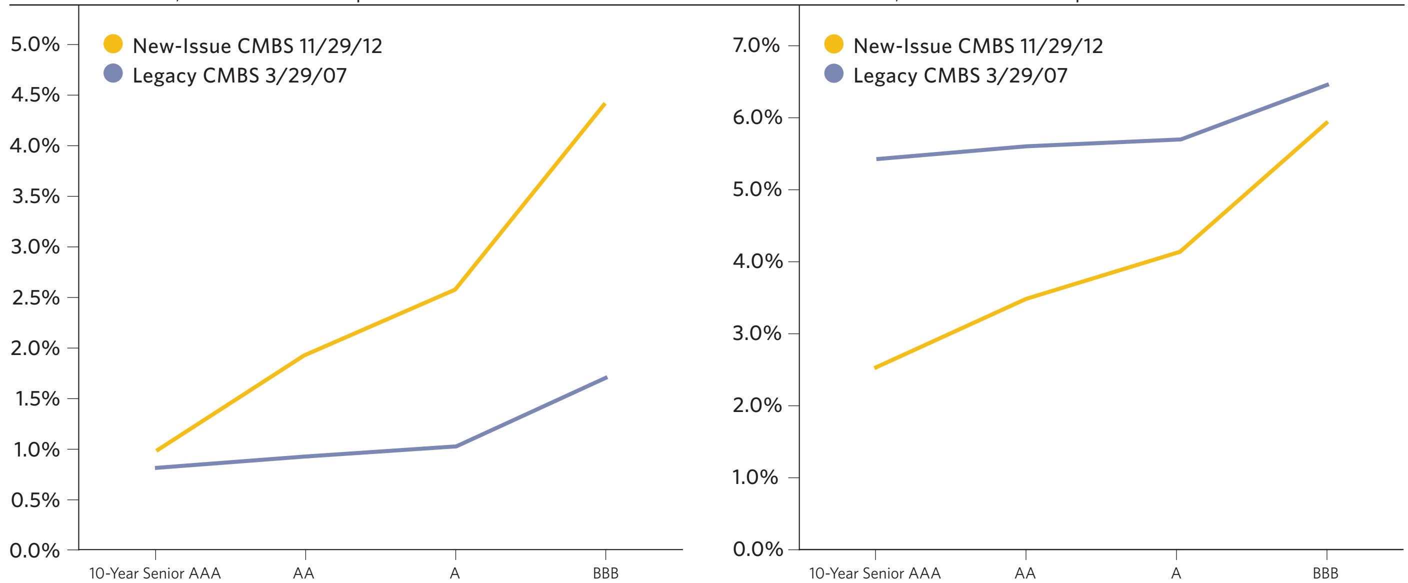
Commercial real estate prices are like

FIGURE 2

COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS) SPREADS AND YIELDS, THEN (2007) AND NOW (2012)

SPREADS TO TREASURIES: CMBS Credit Curve, March 2007 and September 2012

YIELDS: CMBS Credit Curve, March 2007 and September 2012



SOURCE: JPMorgan Securities

prices of stocks or bonds in that they represent investors' assessments of the net present value of future income streams. The more bullish investors are about future net incomes, the higher the price; the more bearish, the lower the price.

In commercial real estate, the relationship between the net operating income (NOI) and the price is the capitalization (cap) rate (cap rate = NOI/price).

At present, on a historical basis, cap rates are near but not at their all-time lows—meaning that investors are paying relatively high prices for commercial property income. That manifests itself in lower returns for investors.

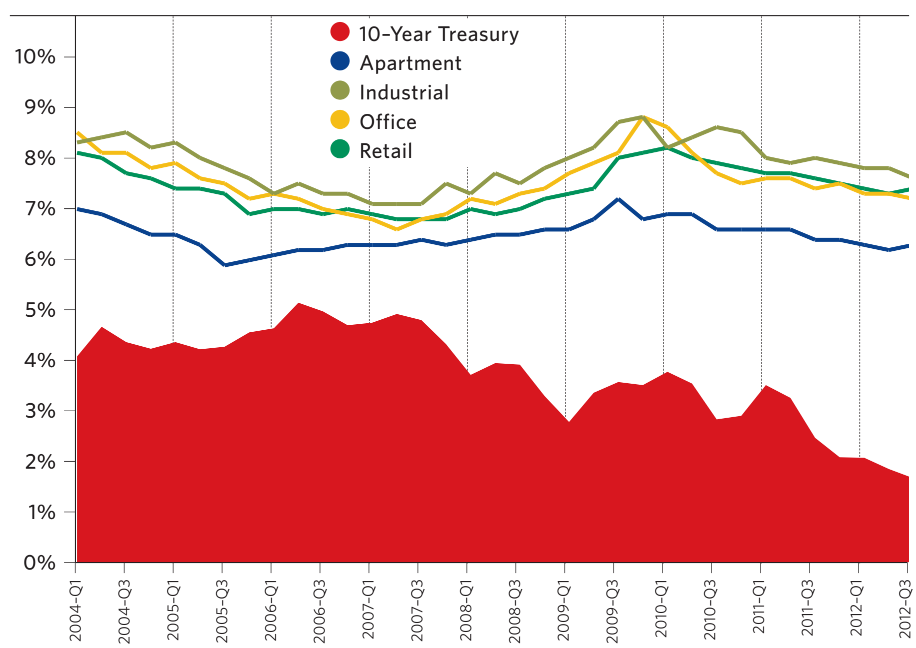
According to Real Capital Analytics Inc. (RCA), New York, the average third-quarter 2012 cap rate for apartment properties was 6.2 percent—just above the series low of 5.8 percent from the co-op conversion period of 2005, but well below the 8.6 percent seen when the series started in the beginning of 2001 (see Figure 3).

Similarly, third-quarter 2012 average office cap rates of 7.1 percent were higher than the 6.5 percent lows of 2007, but well below the 9.8 percent levels seen in 2001.

But these are just averages. The November acquisition of the Archstone Inc. portfolio of apartment buildings by Chicago-based Equity Residential and Arlington,

FIGURE 3

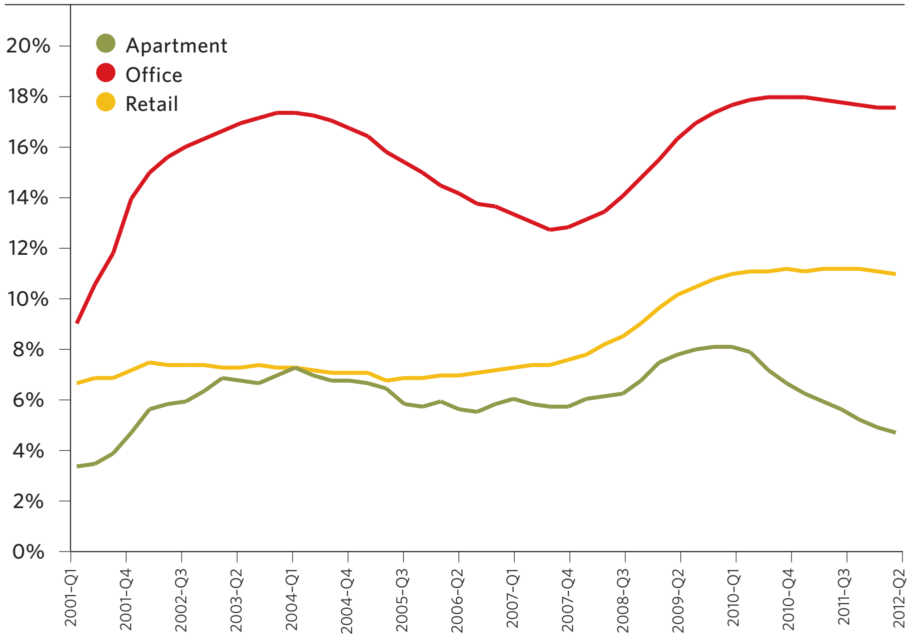
COMMERCIAL/MULTIFAMILY CAPITALIZATION RATES



SOURCES: Real Capital Analytics and Federal Reserve Board

FIGURE 4

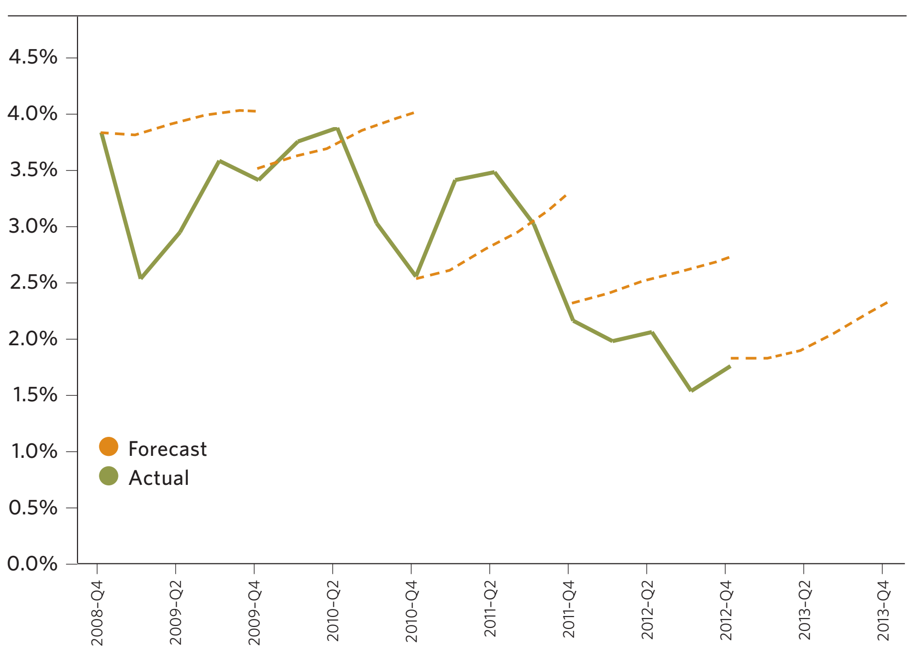
COMMERCIAL/MULTIFAMILY VACANCY RATES



SOURCE: Reis Inc.

FIGURE 5

10-YEAR TREASURY YIELDS (ACTUAL AND Q4 PHILLY FED FORECAST)



SOURCES: Federal Reserve Board, Federal Reserve Bank of Philadelphia

Virginia–based AvalonBay Communities Inc. was reported to come in at a cap rate of less than 5 percent.

And since hitting their lows in September 2009, prices for central business district (CBD) office properties have climbed 71 percent, while prices for suburban office properties have risen just 10 percent.

So again, while cap rates are low in absolute terms, in relative terms they have been remarkably wide.

According to New York–based Clarion Partners LLC, the long-term (1990–2010) average spread between the 10-year Treasury and commercial property cap rates is 278 basis points, but has ranged from less than zero to more than 500 basis points immediately after both the 2001 and 2008–2009 recessions. Today, the spread between the 10-year Treasury rate and the average 6 percent cap rate for an apartment property (and even the sub-5 percent cap rate paid for the Archstone portfolio) is well above the long-term average (6 percent cap rate minus 1.6 percent Treasury rate equals 440 basis points).

Today's commercial property investors are choosing to put their money to work in properties that provide returns that are low on an absolute basis, but high relative to many other investment options.

Property performance

Assessing today's property markets is another study in relativity, particularly in placing debt that will mature in seven to 10 years.

Office, retail and industrial markets have largely been tracking the U.S. economy as a whole. Growth, but slow growth, in the U.S. economy has meant growth, but slow growth, in demand for commercial space.

According to Reis Inc., New York, vacancy rates for office properties peaked at 17.6 percent at the end of 2010 and they have since fallen to 17.2 percent (see Figure 4). Likewise, vacancy rates for retail space were at a cycle high of 11 percent for much of 2011 and fell to 10.2 percent in the second quarter of 2012.

Despite the fact that vacancy rates for these property types remain high in absolute terms, falling vacancy rates and growing asking rents—even if growing slowly—are helping boost NOIs relative to where they have been. Given the low hurdle investors are looking for in terms of yield, even these slight improvements can be significant.

The apartment market is experiencing

a different set of conditions and trends. According to the Census Bureau, since the end of 2006 the homeownership rate has fallen from 68.8 percent to 65.3 percent. That, coupled with the addition of 4.4 million households, has meant an increase in demand of 5 million rental units and a decrease in demand of 1.5 million ownership units.

The impact on rental vacancy rates tracked by Reis has been equally dramatic—a drop from 8 percent at the end of 2009 to 4.7 percent in the second quarter of 2012. The rise in demand has had a similar effect on asking rents and NOIs, each of which are now at record highs.

Today's investors and lenders are underwriting office, retail and many other properties in conditions that are currently soft but showing signs of improvement, and multifamily rental properties in conditions that are among the tightest they have seen.

THE QUESTION OF INTEREST RATES

With interest rates at the core of many of these benchmarks, commercial real estate markets will be heavily impacted by the route they take.

Unfortunately, economists have been less than perfect in their recent prognostications on rates.

In the fourth quarter of 2009, the Philadelphia Federal Reserve's Survey of Professional Forecasters consensus forecast projected that over the next year, the 10-year Treasury interest rate would rise from 3.5 percent to 4.0 percent (see Figure 5). Instead, it fell to 2.5 percent.

In the fourth quarter of 2010, the forecast saw rates rising from 2.5 percent to 3.3 percent. Instead, they fell to 2.3 percent. At the end of 2011, the forecast saw rates rising from 2.3 percent to 2.7 percent. In November 2012, 10-year Treasuries stand at 1.6 percent.

The outlook (it's relative too)

Much of the outlook for commercial real estate markets will depend on what happens to some of the key benchmarks against which investments are measured.

Mortgage rates: If interest rates finally bend to forecasters' continued calls and rise (see sidebar), mortgage rates will eventually turn from being a tailwind for financing and refinancing to being a headwind. The currently wide spreads seen among some investor groups, however, would likely compress to absorb some, but not all, of the rise.

In 2013 and 2014, even with an increase, mortgage rates will likely still be well below their 2003 and 2004 levels, meaning properties facing a maturing 10-year loan will continue to see rates as a tailwind. In 2023, however, it is hard to imagine rates as low as they are today, meaning rates are likely to be a headwind for today's 10-year loans when they mature. (For some loans, a 2-percentage-point rise in rates could mean a 15 percent rise in debt-service payments.)

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Property values: Property values have climbed—in some cases significantly—from their post-recession lows, especially for apartment properties and for properties in major cities. A rise in base interest rates will bring upward pressure on cap rates and downward pressure on values. The currently wide cap rate spreads to Treasuries can absorb some of that pressure, but after that, prices will be dependent on the race between increases in interest rates and increases in NOIs.

Should NOIs rise faster than interest rates and cap rates, property prices will rise. Should the reverse take place, prices could face pressure.

Property incomes: The current weakness in most commercial property markets is—perhaps oddly—a net positive for the performance of loans that are made today. To the degree vacancy rates decline and rents increase, a property's ability to meet existing debt service will improve. Multifamily properties present a different prospect. Today's tight vacancy rates have limited room for improvement, meaning rent growth will need to compensate for any increased vacancies and drive income growth.

Commercial real estate vs. anything else: Many of the large economic tremors of recent years have been a few steps (or more) removed from the commercial and multifamily real estate finance markets. The European debt crisis, "fiscal cliff," U.S. debt downgrades and other developments have all had impacts on commercial and multifamily markets, but their impacts have largely been third or fourth degree. This distance makes commercial real estate a relative "risk-off" in the current environment of macro uncertainty.

A still relatively attractive market

Commercial and multifamily real estate markets attract debt and equity because investors view them as providing solid risk-adjusted returns relative to other investment options. In today's economic environment of extraordinarily low returns, commercial real estate investors and lenders face low absolute returns, but returns that remain attractive relative to other benchmarks.

How attractive those returns remain will depend on the future performance of both commercial real estate and the benchmarks against which it is judged. **MB**

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