



Rising Interest Rates

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Executive Summary

- **Data analysis shows that higher interest rates can have a negative impact on the CRE market, including higher cap rates, lower property values, and lower loan origination volume.**
- **CRE experts agree there could be upward pressure on cap rates due to monetary tightening. However, how far and how fast cap rates increase will depend on economic conditions. Cap rate spreads are also a better metric to track for CRE pricing.**
- **Experts are optimistic that even with higher interest rates, CRE prices and loan volumes will continue to perform well.**
- **Apartment/multifamily can benefit from rising rents, Industrial from the growth in e-commerce, and Office and Retail from strong economic fundamentals and domestic capital flows.**

Agenda

01 Interest Rates and the CRE Market: In Theory

02 Impact on Cap Rates

03 Interest Rates and CRE: Empirical Data

04 CRE Market Outlook

05 Considerations

Higher interest rates could theoretically lead to...

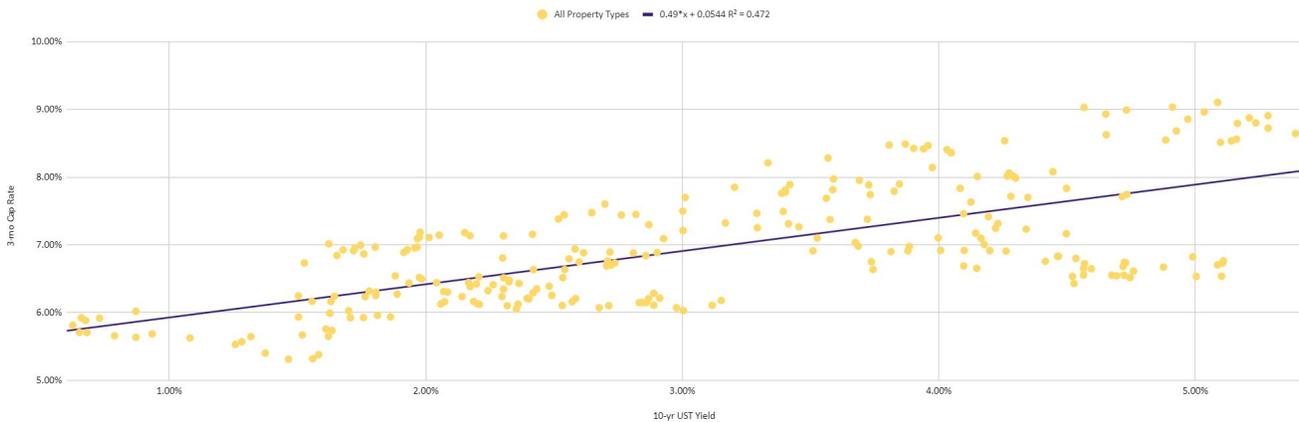
- **Increased capitalization rates**
- **Higher borrowing costs**
- **Lower income from property**
- **Lower property values**
- **Tighter lending standards**
- **Lower demand for refinancing**
- **Lower loan origination volume**

There's a strong, positive correlation between interest rates and cap rates

Correlation with 10-yr UST Yield				
All Types	Office	Industrial	Retail	Apartment
69%	60%	65%	54%	75%

For every 1% point increase in interest rates, we can expect cap rates to increase by...				
All Types	Office	Industrial	Retail	Apartment
0.49%	0.39%	0.51%	0.32%	0.56%

Cap Rates vs. Interest Rates – All Property Types



Office

The demand for office space is cyclical, moving in line with the broader economy. This dynamic causes a more volatile cap rate trend than other property types.

Industrial

Industrial property has benefited from the shift to e-commerce as consumer goods moved from retail shelves to distribution centers. As a result, what was historically the highest cap rate among the four main property types is now lower than both office and retail.

Retail

Demand for retail space moves in a similar fashion to office space demand. Cap rates for retail have remained elevated, despite the cap rate decreases for apartments and industrial properties.

Apartment

Apartment cap rates have generally been the lowest among these four property types, supported by a shorter leasing cycle.

- One-year leases allow apartment owners to reap the benefits of rising rents faster than property types with multi-year lease terms.
- The apartment cap rate has declined steadily since the global financial crisis (GFC), falling below 5% for the first time in 2020.

Higher cap rates lead to higher default risk for lenders

- Any move in cap rates in the 85% LTV scenario creates much greater default risk for the lender.
- Loans with LTVs greater than 75% may need to be closely monitored, due to the increased risk.
- In the future, non-“green” properties could be penalized by the industry, by increased cap rates of 100-200bps.

65% LTV @ Origination	Cap Rate @ Origination							
	Cap Rate Increase	Cap Rate @ Origination						
		4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%
	0.5	73%	72%	72%	71%	70%	70%	70%
	1.0	81%	79%	78%	77%	76%	75%	74%
	1.5	89%	87%	85%	83%	81%	80%	79%
	2.0	98%	94%	91%	89%	87%	85%	84%

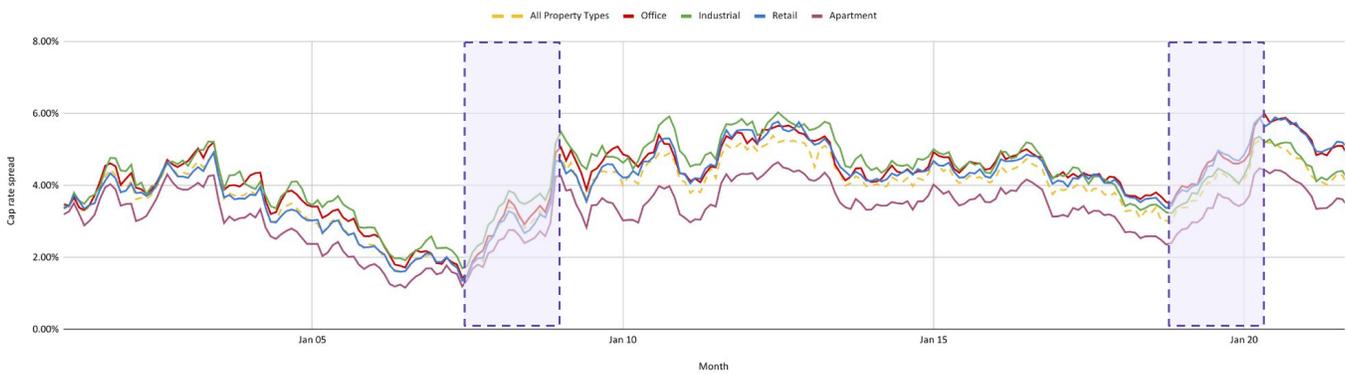
75% LTV @ Origination	Cap Rate @ Origination							
	Cap Rate Increase	Cap Rate @ Origination						
		4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%
	0.5	84%	83%	83%	82%	81%	81%	80%
	1.0	94%	92%	90%	89%	88%	87%	86%
	1.5	103%	100%	98%	95%	94%	92%	91%
	2.0	113%	108%	105%	102%	100%	96%	96%

85% LTV @ Origination	Cap Rate @ Origination							
	Cap Rate Increase	Cap Rate @ Origination						
		4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%
	0.5	96%	94%	94%	93%	92%	92%	91%
	1.0	106%	104%	102%	100%	99%	96%	97%
	1.5	117%	113%	111%	106%	106%	105%	103%
	2.0	128%	123%	119%	116%	113%	111%	109%

However, the cap rate spread is the key metric to watch for real estate pricing

Cap rate spreads widened significantly during the 2007-08 GFC and between Nov 2018-Apr 2020, but have **narrowed since the days of the pandemic**.

Cap rate spread by Property Type



A period of rising interest rates is not necessarily bad. If real estate remains in favor due to growth expectations and/or a better relative risk profile, spreads can compress instead.

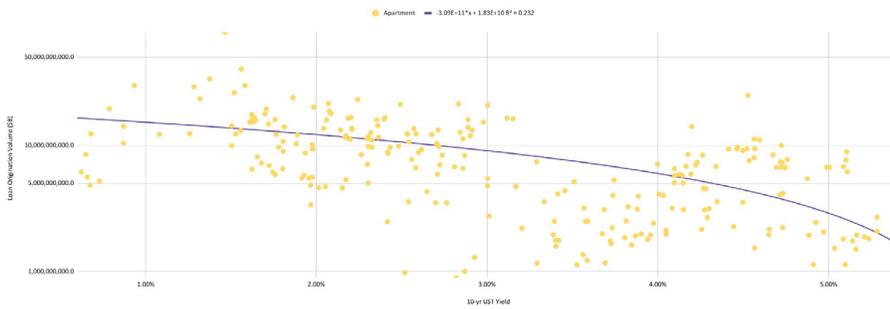
For every 1% point increase in interest rates, we can expect cap rates to <u>increase</u> by...				
All Types	Office	Industrial	Retail	Apartment
0.51%	0.61%	0.49%	0.68%	0.44%

Some analysts think that as mortgage rates rise, the effect on the apartment sector can be positive...

- Higher interest rates may reduce the relative number of home buyers, which will result in increased rental demand.
- Given that the apartment/multifamily sector has shorter term leases, it can frequently reprice its leases to capitalize on increased demand.

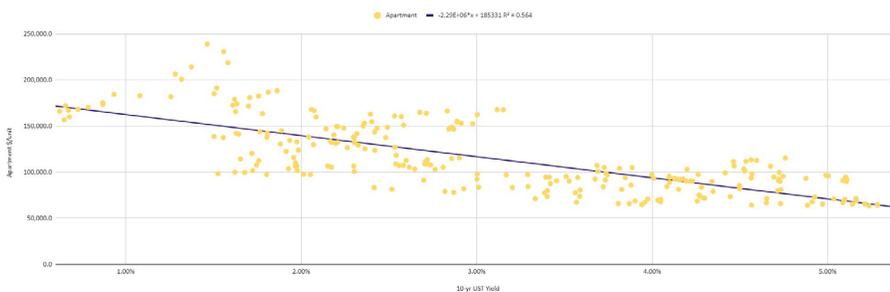
...but the data tells a different story

Origination Volume vs. Interest Rates – Apartment



Apartment loan volume is **48% negatively correlated** with interest rates. For every 1% point increase in rates, monthly multifamily loan volume decreases by ~\$3.1B.

Property Values vs. Interest Rates – Apartment



Property prices are **75% negatively correlated** with interest rates.

For every 1% point increase in rates, multifamily price/unit decreases by ~\$23K.

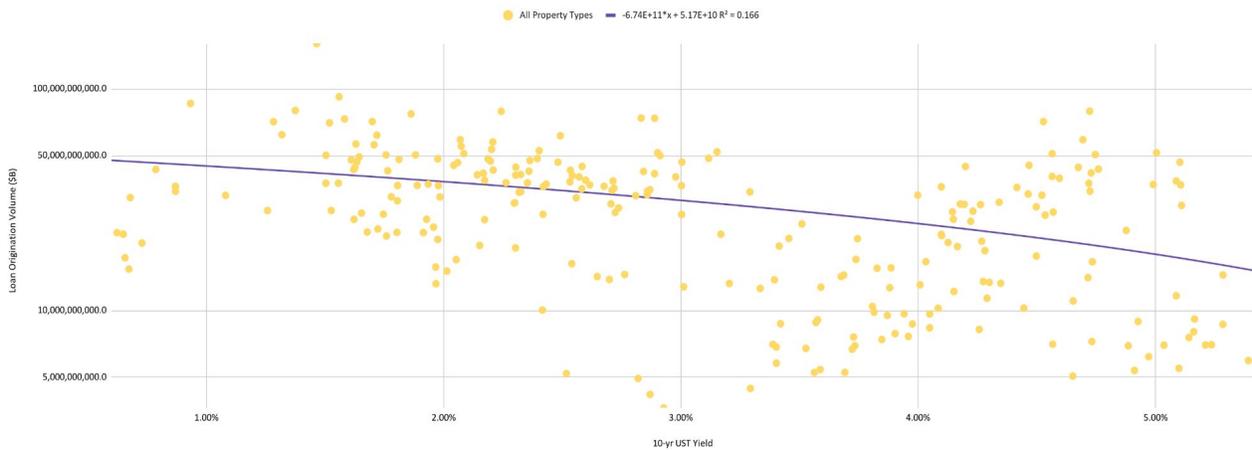
Monthly loan origination volume decreases when rates go up

Correlation with 10-yr UST Yield				
All Types	Office	Industrial	Retail	Apartment
-41%	-14%	-46%	-22%	-48%

% decrease from 2021 monthly average				
All Types	Office	Industrial	Retail	Apartment
10%	5%	12%	8%	11%

...although loan origination volume for the **Office and Retail** sectors seem to be less impacted by higher interest rates.

Origination Volume vs. Interest Rates - All Property Types



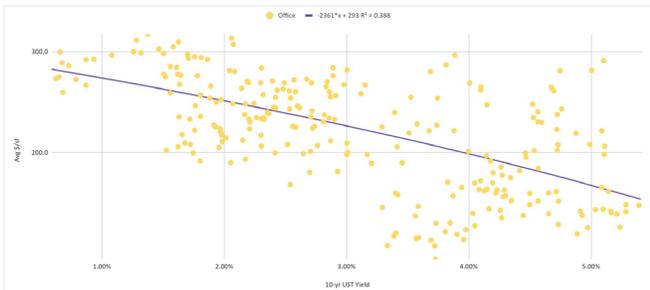
For every 1% point increase in interest rates, we can expect loan origination volume to decrease by...				
All Types	Office	Industrial	Retail	Apartment
\$6.7B	\$0.6B	\$1.6B	\$0.5B	\$3.1B

Property values across all other sectors are also negatively correlated with interest rates

Correlation with 10-yr UST Yield			
Office	Industrial	Retail	Apartment
-62%	-62%	-70%	-75%

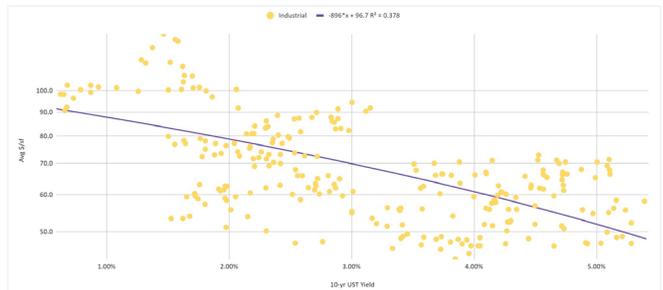
% decrease from 2021			
Office	Industrial	Retail	Apartment
8%	8%	10%	12%

Property values vs. Interest Rates - Office



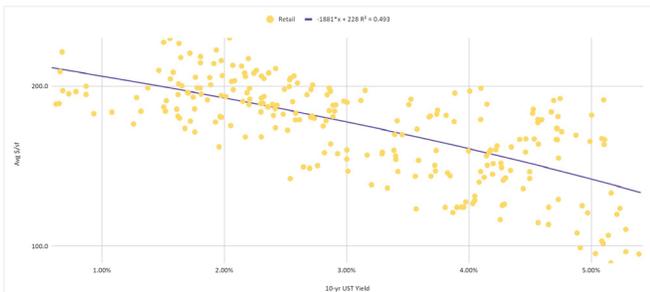
Avg \$/sf decreases by \$23 for every 1% point increase in interest rates

Property values vs. Interest Rates - Industrial



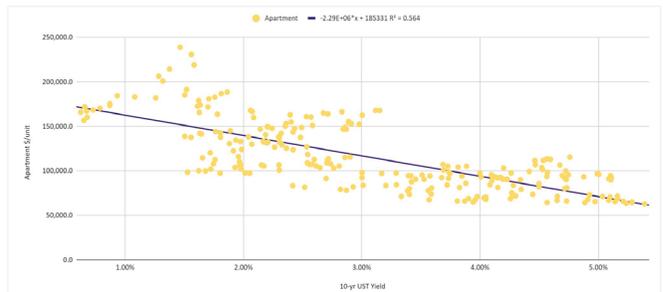
Avg \$/sf decreases by \$9 for every 1% point increase in interest rates

Property values vs. Interest Rates - Retail



Avg \$/sf decreases by \$19 for every 1% point increase in interest rates

Property values vs. Interest Rates - Apartment



Avg \$/unit decreases by \$23k for every 1% point increase in interest rates

Mortgage Bankers Association's Outlook

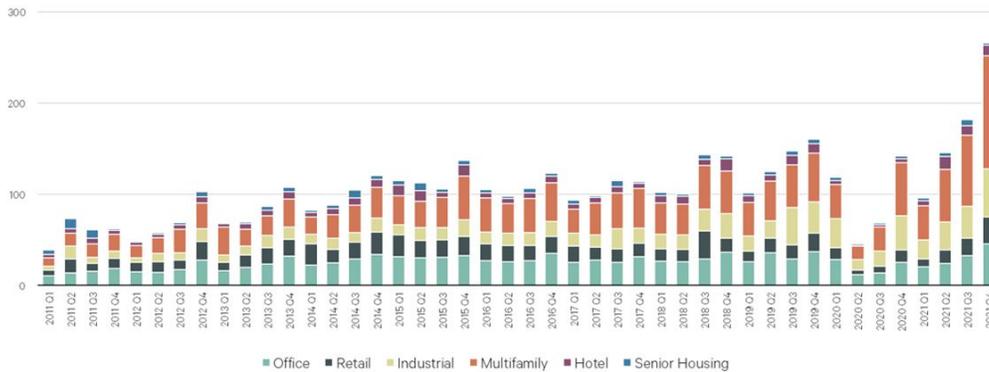
- **Loan volume should not be significantly affected:** general belief is that even with higher interest rates, strong interest from both borrowers and lenders is likely to continue to drive increases in lending and commercial and multifamily mortgage debt in 2022.
- **Slowdown in new development:** higher interest rates will ultimately translate into higher mortgage costs. Combined with other rising costs — for materials, labor etc. — it will be harder to make projects pencil out, which will lead to a slowdown in development.

CBRE's Outlook

- **Loan volume is expected to increase** 5% to 10% over 2021 levels, roughly equal to pre-pandemic 2019 volumes. There's a lot of dry powder that needs to be deployed in the CRE market.
- **Strong demand for assets and rising rents will push pricing higher,** even with minimal increases in long-term interest rates.
- **Multifamily / apartment investment is expected to set new records in 2022:** Mountain West, Southeast, FL, TX, and AZ are the key drivers to acquisition opportunities.
- **Bullish on Industrial** as e-commerce and consumer spending are expected to maintain their recent growth.

Domestic capital flows are also returning to Office and Retail

Office fundamentals are improving dramatically as back-to-office picks up.



Considerations

Interest rates are one of many factors that affect the CRE market. We need to also consider:

- economic fundamentals (inflation, unemployment, GDP growth).
- investor and consumer confidence.
- investment product supply and demand.
- availability of alternatives and relative risk profile of CRE.
- CRE growth expectations.

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