

Commercial Mortgage Insight

“Real Estate Remains an Attractive Investment Vehicle Despite High Valuations”

A cycle of low interest rates has propelled real estate into one of the top performing asset classes for today's investors.

BY MICHAEL HART

Real estate as an investment has enjoyed a paradigm shift from an alternative to mainstream investment choice. Its position as a core asset class was boosted over the last three years when real estate performed well as compared to the stock and bond markets. This was largely a function of the low interest rate cycle. This low rate environment resulted in the well documented windfall to homeowners through the “refi boom” and accelerated prices, which in turn has fed the consumer led recovery. It also enhanced investment real estate returns, as well as dividend driven equities (real estate investment trusts, utilities and financials). By most measures during this period, real estate returns have lead the pack, with value stocks and bonds also outperforming growth oriented equities.



As a broad generalization, by mid-2005 institutional real estate has arguably become overvalued relative to both the stock and bond markets. We assume the 10-year treasury settles at around 5% after the Fed ends its tightening in 2006.

This means the effective PE multiple on treasury bonds (the least risky asset available) will be 20 (note a 5% return is the same as a 20 PE). It was recently as high as 25 PE (i.e. 4% return) after Katrina. This compares to the S&P which has traded at 17-18 PE (6% effective yield of earnings to stock price) with earnings increasing at annualized double digit levels. By this measure, in an increasing rate environment, stocks would seem to offer a better yield with greater potential for capital appreciation versus bonds. The stock/bond value differential has started to correct in that the stock market has rallied of late, as oil prices have receded and investors start to believe the continued low inflation with earnings expansion beyond the fed rate hikes support higher multiples.

Institutional investment real estate values in major urban markets have escalated to expensive levels. This has been largely due to increasing amounts of capital flowing out of other assets into real estate. Real estate has been viewed as more predictable/less speculative after the 2001 stock market bust. In some markets, “core” institutional investors and have paid as high as 17-20 (5-6% cap rates) times pre-debt earnings. This reflects very little yield premium over a risk less treasury bond. Institutional real estate buyers expecting to outperform bonds on a risk adjusted basis are

therefore implicitly expecting either a) cap rates to continue going down (improbable in an increasing rate environment) or b) in place rents to increase. In many cases rents already exceed levels necessary to support new construction. History has shown that excessive rents generate new construction, which portends the possible relative future underperformance of these investments.

Real Estate cap rate compression has pushed value investors at all levels of the market to assume greater risk to achieve the same returns or alternatively to lower return expectations. Currently targeted leveraged IRR returns are 9-11% for institutional core equity and mid-teens for value which are well below traditional expectations. In “for sale” housing (condo conversion/construction projects) which required underwritten 25% margins are now, in many cases, actually closer to 15% due to the combination of aggressive cap rates as well as both escalating material costs and interest rates. Despite the expected excess continued liquidity in the market, prudent underwriting of investment real estate should be requiring higher capitalization rates (lower PEs) reflecting the higher costs of leverage. This pricing adjustment has for the most part not yet occurred. This can be partially explained by a couple of factors: 1) cap rates usually lag interest rate moves to some degree and

2) the continued influx of foreign institutional money that is often not as interest rate sensitive because they are all cash buyers, who benefit from yield enhancement from the currency trade due to the relatively weak dollar.

The escalating values described in commercial real estate have also been true of the housing market with some highly noted sub-markets having experienced annual increases over 30% over the last several years. It has been sighted by economists that housing affordability is at historical lows despite the rampant use of ARMs. There has clearly been some softening in the condo market in certain geographic regions. While this is a concern, we believe it will require the combination of significant job losses and continued increases in interest rates (highly unlikely to occur simultaneously) to cause a widespread crash in (the infamous “Bubble Burst”) housing. Most experts logically project a continued softening in prices reflecting the ongoing increasing rate cycle, with the regions experiencing the most rapid price escalation most susceptible to incurring a more significant correction.

The year 2006 should see competing pressures on investment classes as the economy grows at a steady but slower rate. Expect to see a continued shift in leadership in relative performance. Cyclical and growth stocks as well as commodities that benefit from the increased business capital expenditure demand (usually experienced later in the economic expansion) should continue to enjoy upward growth versus value and fixed income investments including real estate. However, the rising tide of the continued expansion should be positive for underlying real estate fundamentals as demand absorption results in tightening occupancy and rental increase. As in the past, real estate will continue to provide a stable, long-term inflation hedge and diversification that is highly desirable. Real estate values will continue to be highly dependant on the level of interest rates. Some caution is advisable

as the market escalation experienced over the last three years is no longer being fed by low interest rates. While values always reflect local market dynamics, the general the magnitude of the macro pricing correction will depend on where the Fed rate hikes stop, and what inflation premium gets dialed into the longer term treasury yield.

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