FOCUS ON INVESTMENT CONDITIONS

Financial Risk Management—Understanding Returns

BY KENNETH RIGGS, JR., CRE

When the Federal Reserve reversed course by raising the federal funds rate and signaled their intent to continue raising rates in order to keep inflation in check, investors began contemplating how much higher interest rates will go over the next couple years, and more importantly, how quickly the increases will occur. As one of the key drivers of real estate values, low interest rates are credited with allowing investors to receive, on average, record appreciation, despite poor space market fundamentals. The expectation is that as interest rates go higher, however, the interest rate environment will not continue to bail out poor space market fundamentals and real estate values. Since institutional investors generally have an abundance of investing options available to them, this column focuses on determining what returns are fair and reasonable for real estate, given the degree of risk for real estate, as compared to returns for 10-year T-bonds. As our industry moves forward in maturity, financial risk management will be the key to successful investing.

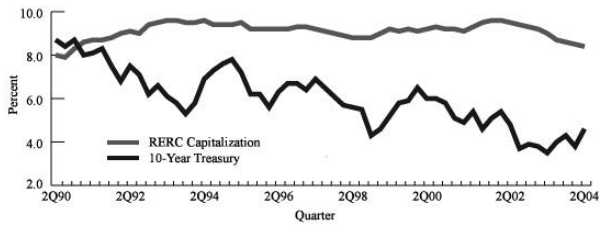
One way to derive an appropriate level of return is to examine the required overall capitalization rate (OAR) data provided each quarter in the RERC Real Estate Report. Rather than using the data straight from the investment report, a Counselor can use the reported OAR and analyze the relationship of the historical spread of the required OAR versus 10-year T-bonds. In the past, this spread generally has ranged between 200 and 400 basis points. At an OAR of 8.4 percent (this is an average for all property types with an average earning structure), RERC's average required overall capitalization rates are the lowest they have been in approximately 15 years. However, at approximately 400 basis points, the spread between required overall capitalization rates and 10-year T-bonds remains near an all-time high.

This reflects the cyclical relationship of current returns, but secular financial trends analysis indicates this spread may be too wide and that the pricing of real estate in the form of overall capitalization rates should continue to decrease. Keeping in mind that the concern is the speed of future increases in interest rates, today's wide spreads are probably reasonable given the direction interest rates are heading. This wide spread acts as a risk premium if interest rates increase faster than what is expected.

Generally speaking, as 10-year T-bonds increase or decrease, required overall capitalization rates for real estate slowly follow the same pattern, as shown in Figure 1 (RERC Required Overall Capitalization Rates vs. 10-Year T-Bonds). Since real estate competes with other assets for capital, increases in risk-free investment rates should motivate real estate investors to require higher returns on investments with a higher degree of risk, thereby creating higher capitalization rates. Figure 2 (Spread Between Overall Capitalization Rates and 10-Year T-Bonds) illustrates the yield relationship of RERC's required overall capitalization rates and 10-year T-bonds with the spread showing a continual increase from 1990 to today. This above-average spread will tend to keep capitalization rates stable in anticipation of interest rates increasing, and allows for cyclical movements in interest rates to keep the spread normalized and prices relatively steady in the short-term.

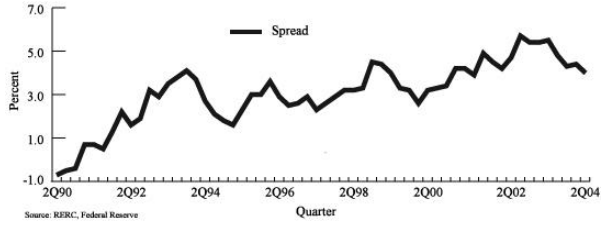
The use of this higher spread allows investors to avoid the cyclical movements in the financial markets that real estate

Figure 1—RERC Required Overall Capitalization Rates vs. 10-Year T-Bonds



Sources: RERC, Federal Reserve

Figure 2—Spread Between Overall Capitalization Rates and 10-Year T-Bonds



Sources: RERC, Federal Reserve

markets cannot quickly adapt to, thereby reducing the potential negative impact on values and prices if rates unexpectedly move upward. It is also important to note that the relatively high capitalization rates specified by respondents in RERC's survey, as reported in the RERC Real Estate Report, indicate that investors are starting to adjust their spread over T-bond expectations because they are concerned that the drop in 10-year T-bonds is cyclical and temporary, and do not wish to buy properties at too low a capitalization rate, given that T-bonds could rise quickly. As discussed previously, this is appropriate given the direction of interest rates.

RERC's forecast is for a normalized spread of 200 to 400 basis points over equal-term 10-year T-bonds for required overall capitalization rates to continue during this period of increasing interest rates. For example, if investors anticipate 10-year T-bonds to be 5 percent, investors should use average required overall capitalization rates around the 7- to 9-percent range (200 to 400 basis points higher than T-bonds) to compensate for the risk associated with their investment. This reflects RERC's view for average institutional core properties that have solid cash flows, various lease durations, and tenant credit quality.

Since no two properties are identical, especially when it comes to location, occupancy, tenant quality, age, and condition of the properties, investors need to evaluate all their properties in determining appropriate capitalization rates. We are quick to throw in the mix that in developing this analysis one must remember that the OAR has a growth component that influences the spread and the level of return. Further, the OAR is a one-year rate (but has imbedded level durations of longer periods) versus the obvious term for the treasury issue. In the end, this is one way to ascertain the appropriate level of return given the level of risk. The use of a spread allows you to take cues from the financial market about risk-free rates, imbedded inflation expectations, and overall levels of expected returns.

FINANCIAL RISK MANAGEMENT

■The rising interest rate environment is a reflection of the expected inflationary economic growth over the next several years.

■Expanding business environment will put upward pressure on income for real estate, which is a result of increasing rental rates and decreasing vacancy rates.

■The growth expectations for income will allow OAR to remain stable, even as interest rates begin to increase.

■As the economy continues to expand, income within the real estate sector will follow suit and increase. This will allow total returns to increase, even as capitalization rates stay flat or rise slightly.

■Overall, the risk and return profile of commercial properties compared to alternative investments will improve as the economy expands and income for commercial real estate increases.■

About our Featured Columnist

Kenneth Riggs, Jr., CRE, is chief executive officer of Real Estate Research Corporation (RERC). RERC offers research, valuation, independent fiduciary services, portfolio services, corporate advisory services, litigation support, and other real estate-related consulting services. RERC also provides research, analysis, and investment criteria (cap rates, yield rates, expense and growth expectations, recommendations, etc.) for nine property types on a national and regional level and for 40 major U.S. markets through the quarterly RERC Real Estate Report, the annual Expectations & Market Realities in Real Estate, and the RERC DataCenter.