WHEN IS THE RIGHT TIME TO JUMP BACK IN?

January 25, 2023

INTRODUCTION

Given that short term interest rates for commercial real estate have doubled since March of 2022, we are often asked: Are you finding any opportunities? When is the right time to get back in? How are you getting opportunities to pencil? By our estimates, depending on the product type, real estate values are down 15% to 35%. Notwithstanding this sharp drop, there is not material distress in the markets because 1) most real estate owners entered this cycle with strong balance sheets and 2) we are only 10 months into this new interest rate reality. The result is everybody went to the side lines to wait, which resulted in a 60% drop in transaction activity. There is almost no buying or selling going on today. The only real transactions are corporate sellers or best-in-class assets getting sold in the 10%-15% discount range to rebalance a portfolio. So, the question is, how long will this last? When will the market recognize a reset in values and when will we see transaction activity pick up again? Employment is still strong, and it appears inflation is slowly coming down. So when will interest rates level off? We asked Randy Zisler to take a historical look in order to help us see a window in the future based on this historical perspective. We estimate that we will see a depressed real estate market for another 9-12 months. After that, assets should start to see appreciation again.

INVESTMENT RECOMMENDATION: NOW IS THE TIME TO ACT

The recent interest rate spike was relatively small in absolute terms when compared to the early 1980s. Rates are still low compared to 50 years of history. However, given the already low interest rates, the impact of the raising rates was significant, but in our view, will likely be short-lived.

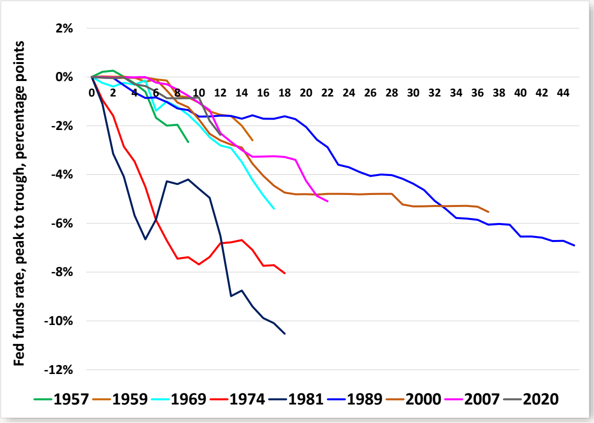
Exhibit 2 shows the peak-to-trough paths of nine interest rate spikes. Exhibit 3 is a histogram of the timing of these paths. The mean gap is 21 months and the median is 18 months. This would suggest that our window of opportunity is 18, maybe 24 months.

Interest rates started rising in March of 2022, some ten months ago. If history is a good indicator we will see interest rates level off in the second half of 2023.

Exhibit 1. The 10-year Treasury yield is high but it is low relative to late 1970's peaks.

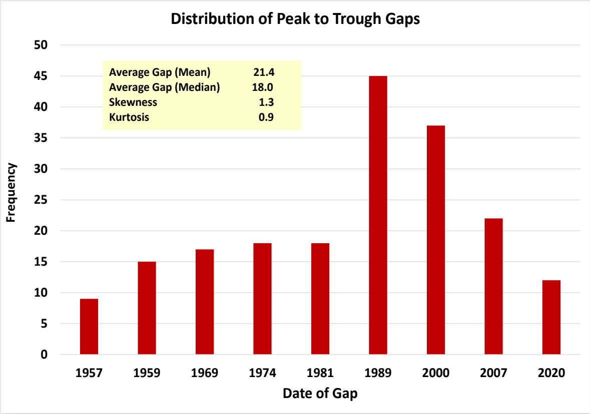
Source: COSTAR

Exhibit 2. Interest rate cycles vary in their duration and severity.



Source: COSTAR

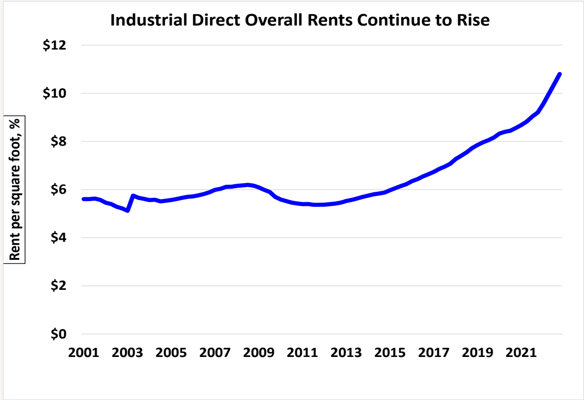
Exhibit 3. There is a 21-month gap between interest rate peaks and troughs.



Source: Zisler Capital Associates, LLC

WHICH ASSET CLASS WILL REBOUND THE QUICKEST?

Exhibit 4. Industrial rents are rising.



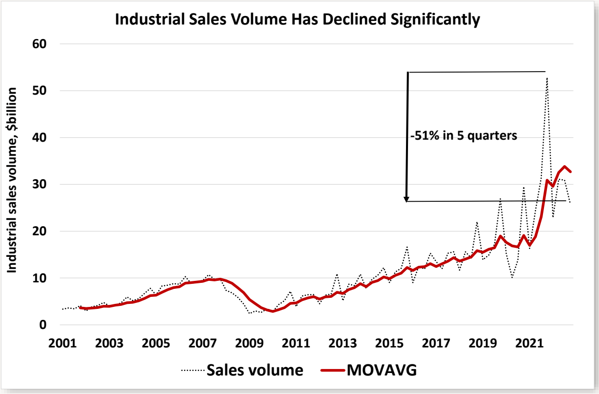
Source: COSTAR

We suggest Industrial real estate will be a leader in the interest rate recovery. Industrial rents are still rising due to very low vacancy rates. The demand for industrial space is robust and growing. SKB's own industrial Portfolio saw net absorption of 190,000 feet during 2022 or about an 8% increase in occupancy.

SKB

Despite rising rents, industrial sales volume declined 51% due to the impact of the interest rate increases. However, relative to historical sales volume, current transactions volume remains significant as some owners must trade. We expect volume to increase as interest rates stabilize or decline.

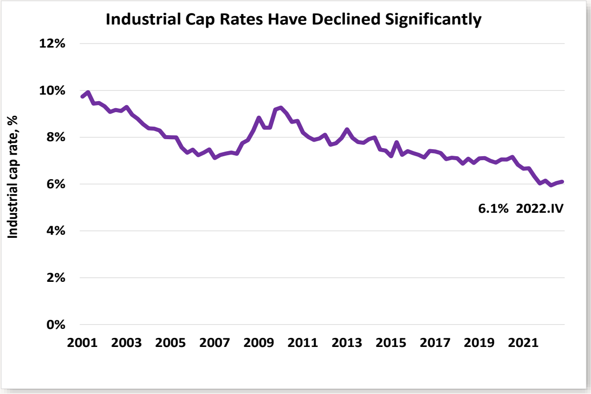
Exhibit 5. Industrial sales volume fell 51% during the last five quarters, but some significant transactions volume remains.



Source: COSTAR

Aggregate industrial cap rates, which have generally declined since 2010, have reached an apparent floor but have not, as yet, increased. Since movements in cap rates are sluggish and lagged, we do not expect much, if any, increase in industrial cap rates as long as interest rates fall within the aforementioned window.

Exhibit 6. Industrial cap rates remain low; they have declined over 300 bps since the Global Financial Crisis but may have reached a floor.

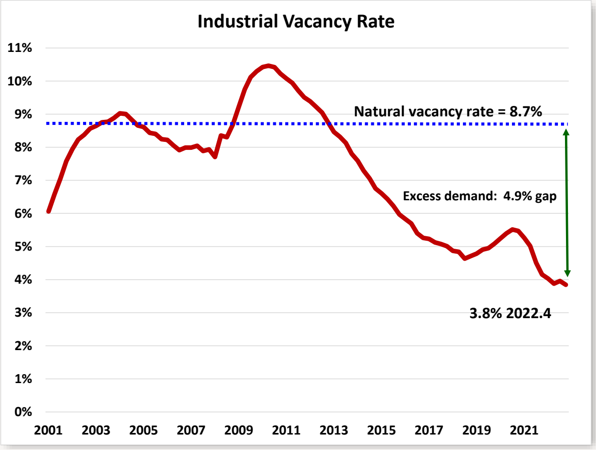


Source: COSTAR

The operational side of the industrial property sector is robust: Vacancy rates remain at a historic low of 3.8%. The natural vacancy rate, which we estimate to be 8.7%, is that rate at which rents are neither rising nor falling. The gap reflects significant excess demand.

Thus, rising rents, still low cap rates and low vacancy rates indicate that the rise in the industrial inventory, is not as yet a problem.

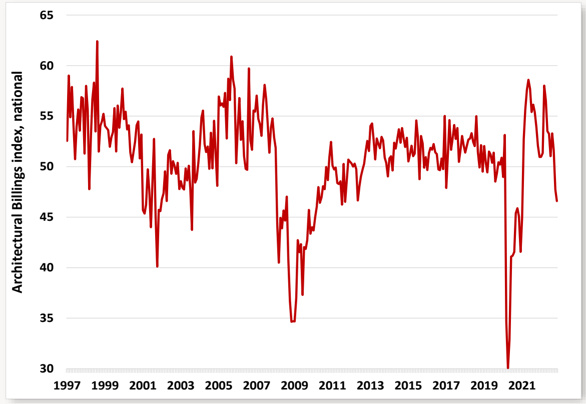
Exhibit 7. Industrial vacancy rates are very low.



Source: COSTAR

Exhibit 8. Architectural billings are dropping.

Developers remain cautious, however. Architectural billings, a leading indicator of development activity, has slipped 20%, reflecting yet another impact of interest rate increases. The last time this index fell significantly was from February 2020 to April 2020: A 43% drop in just three months. At the onset of the Global Financial Crisis, billings dropped 41%. (See Exhibit 8.)



Source: AIA

Even though recorded loan origination data, a lagging indicator, indicates no drop in loan volume, in the field we see a reduction in loan originations and more onerous terms that include rising rates, lower loan-to-value ratios, and more onerous underwriting assumptions. The data should eventually record a downward adjustment in land prices. Real-time, we are observing developers who have optioned land walk away due to the increased costs of carry. In some cases, developable land prices have declined 20%. Loan delinquencies for investment grade and non-investment grade loans are not significant. Still, traditional lending institutions are cautious.

CONCLUSION

We maintain that rising interest rates have created a window of opportunity for fresh capital, but the window, we estimate, will not remain open for more than 9 to 15 months. Many traditional institutional equity sources, such as pension funds, will not be able to act expeditiously; often their underwriting processes are “rear view” looking. Fleet-of-foot private equity funds, especially those that can acquire all-cash, should be able to fill the gap. You should start seeing opportunities from SKB in the next 4 to 6 months.

TODD GOODING

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