PROPERTY RECOVERY IS STILL A WAYS OUT

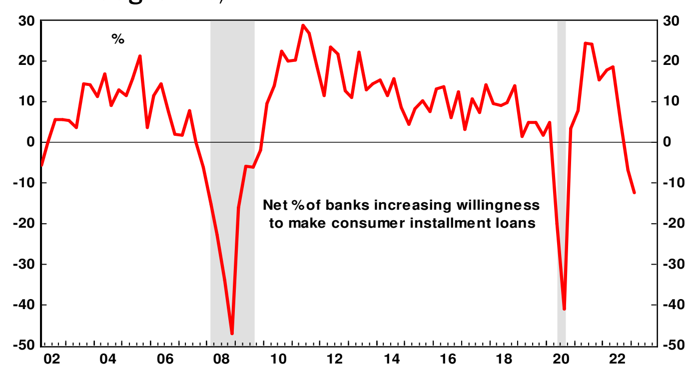
April 25, 2023

INTRODUCTION

We suggested when we last wrote that the market would remain depressed for another nine to twelve months. Since then, short term interest rates have increased mostly as expected—an increase of 25 basis points in March and another 25 basis points are anticipated in May. However, the crash of Silicon Valley Bank and other lenders has contributed to additional credit tightening and non-price rationing, which includes more onerous terms, such as lower loan-to-value and higher debt service coverage ratios. This is affecting all sectors of Real Estate.

Credit remains tight. Bank willingness to lend is declining, as shown in Exhibit 1. The downturn in property transaction volume, a measure of illiquidity, as shown in Exhibit 2, largely reflects non-price credit rationing. Non-price rationing is a symptom of hidden information, which reflects the perceived increased risks lenders face. Lenders are augmenting reserves in anticipation of increased bad loans.

Exhibit 1. Bank willingness to lend, an indicator of credit tightness, has declined.



From 2021Q4 to 2023Q1, transactions volume declined 79%, See Exhibit 2. A byproduct of this decline is impaired price discovery, which challenges the underwriting of investors and lenders alike. With poor price discovery comes increased market inefficiency: Prices convey less information and uncertainty increases.

The sales volume preceding and during the GFC fell 88% over seven months. Exhibit 3 shows that higher interest rates and weaker property demand reduced total returns for all properties.

Exhibit 2. All-property transactions volume has dropped precipitously.

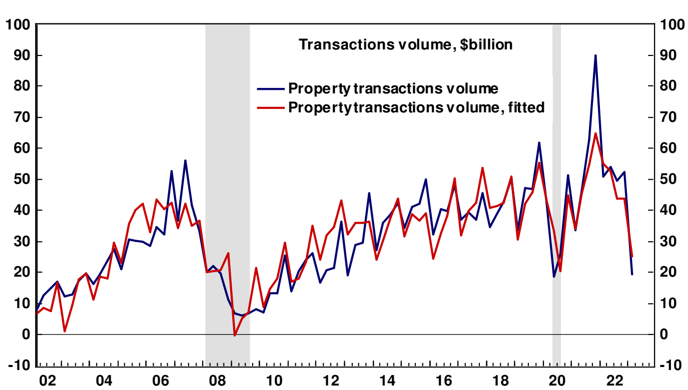
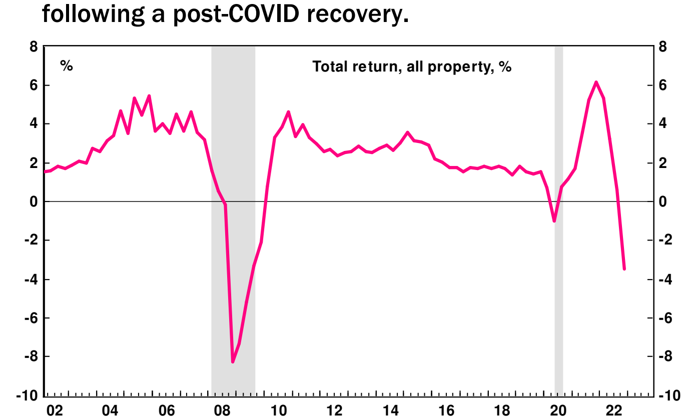


Exhibit 3. NCREIF total property returns are falling following a post-COVID recovery.

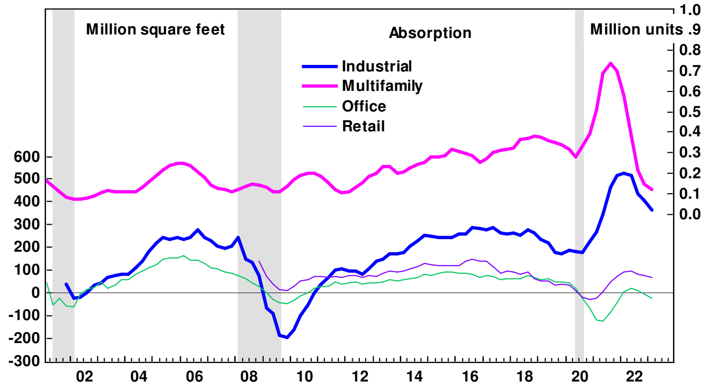


Source: COSTAR

Vacancies impact on Liquidity/Lending

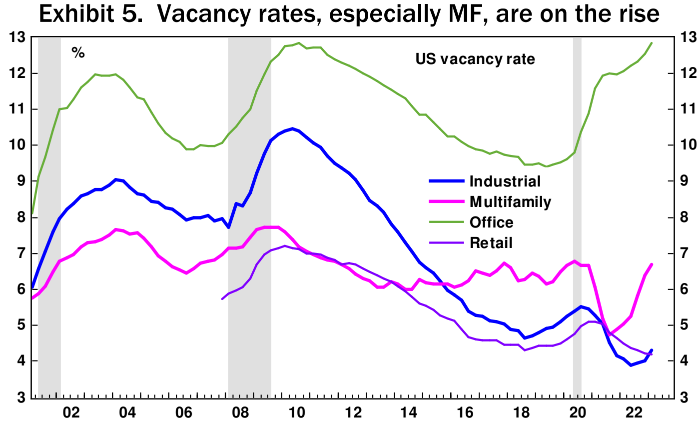
The Banks might have valid concerns about their reserves regarding some property classes. As shown in Exhibit 4, since the last recession, office absorption rates have been negative. While still positive, a 4-quarter moving average of multifamily unit absorption has declined about 39%; by contrast, industrial absorption declined by 57%, but from a lower level of 35 million square feet. The last time multifamily absorption levels were as low as the current rate was in 2012Q2.

Exhibit 4. Absorption is declining for MF and industrial



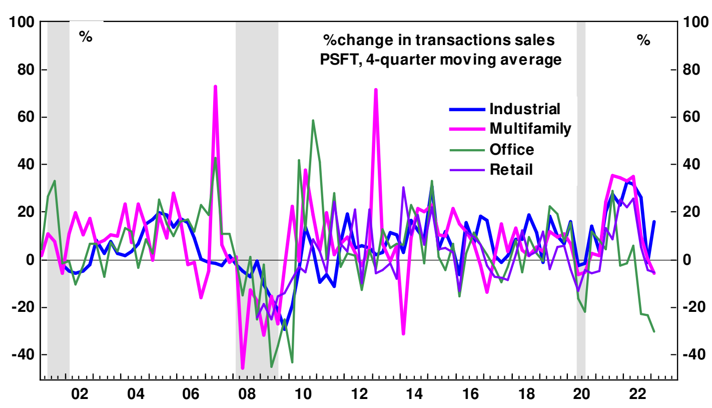
Since the fourth quarter of 2015, industrial vacancy rates have been less than or equal to multifamily vacancy rates. Industrial vacancy rates exhibit three times the relative volatility of multifamily vacancy rates and yet industrial sales per square foot are less volatile than multifamily prices per square foot. Despite greater historical volatility, industrial vacancy rates today are well below multifamily vacancy rates. Office vacancy rates nationally are approaching 15%.

Exhibit 5. Vacancy rates, especially MF, are on the rise



The change in multifamily and industrial sales prices per square foot were comparable from 2012 up to the COVID recession. Since COVID, the rate of increase of industrial sales prices has outpaced multifamily. Today, multifamily sales prices are not growing. The sales price per square foot of office space has fallen the most.

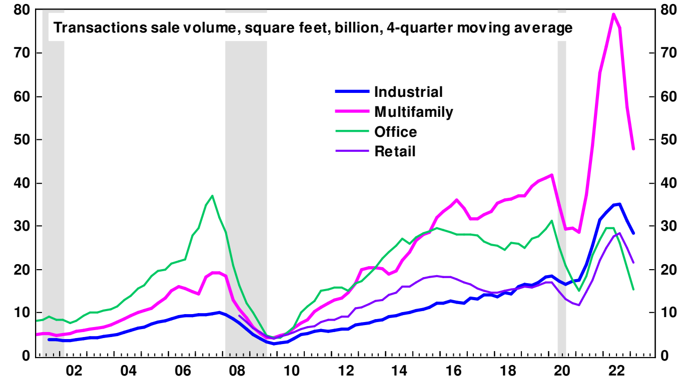
Exhibit 6. The change in sales price per square foot of industrial and sales price per unit have declined.



Source: COSTAR

Exhibit 7 is a 4-quarter moving average of transaction volume, which, while not reflecting the most recent quarterly decline, more clearly shows the relationship among multifamily, industrial, retail and office. Multifamily sales volume since its most recent peak has declined proportionately (-87%) more than industrial sales volume (-77%). Both corrections are significant. The deterioration in volume and price discovery increases the importance of careful evidence-based underwriting.

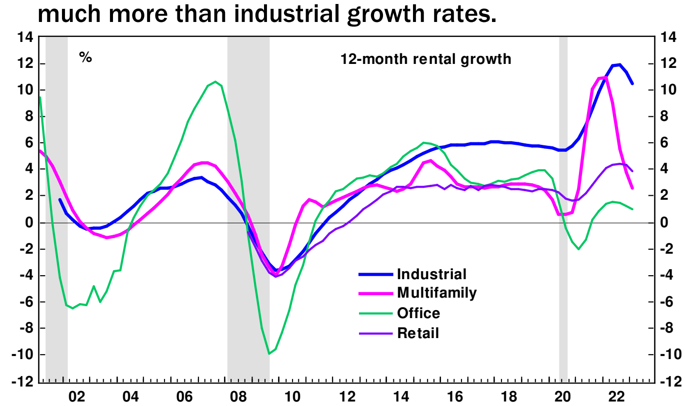
Exhibit 7. Industrial and multifamily sales volume has declined significantly.



Multifamily, 12-month, rental growth was nearly zero during COVID; it rose rapidly immediately thereafter and then began a steep decline beginning in the first quarter of 2022. Industrial peaked two quarters later, but its rental growth decline has been relatively small by comparison.

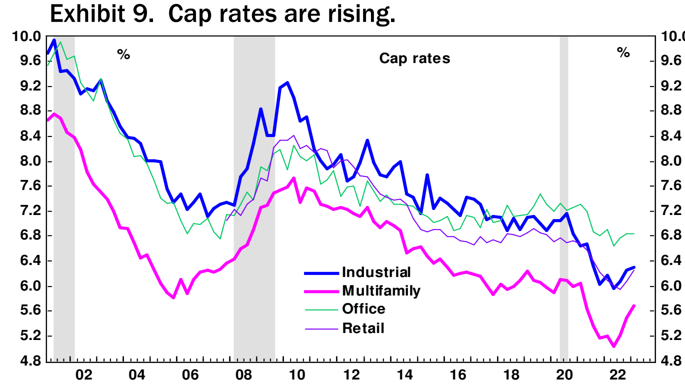
Cap rate data is finally reflecting what is happening in the market: Office and multifamily cap rates are rising.

Exhibit 8. Multifamily rental growth rates have declined much more than industrial growth rates.



Multifamily cap rates have risen about 68 basis points on average, whereas industrial cap rates, characteristically greater than multifamily cap rates, have increased only 33 basis points. While not reflected here due to the lack of bank interest in increasing their book of office loans, cap rates for office have increased dramatically; some markets are exhibiting 10% office cap rates for the first time in 25 years.

Exhibit 9. Cap rates are rising.



Source: COSTAR

CONCLUSION

In the previous issue, we maintained that the downturn is creating a window of opportunity for investors who are discerning, well capitalized, and fleet of foot. We have not changed our view. While the downturn in transaction volume hurts price discovery and makes the market less efficient, investors and their advisors who are close to the market should still deliver attractive returns in the next 6-15 months as they recapitalize troubled assets that remain in the hands of distressed owners.

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