Relative Yield Shows CRE Values Remain High

Expectations for commercial property value growth vary widely among key market participants. Do values have further to fall? Are they stabilizing or have they already started to recover from their cyclical trough? Roofstock Research performed our own analysis focusing on the relative yield offered by the sector in comparison to previous cycles. Our conclusion is that values likely have further to fall, but rapid moves lower may be avoided given the nature of valuations, forbearance by banks, and the fact that, unlike the previous three real estate cycles, this value cycle has not been accompanied by a recession – at least not yet.

For this analysis we used the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index[i] (NPI) values through the first quarter of 2024 (the latest quarter of data currently available). This is an important distinction as NPI current, or book values, are for assets held in institutional portfolios. These are not the market values of assets transacting in each period, although some buying and selling influences value on the margin. NPI value metrics are reflective of quarterly appraisals and historically have experienced varying degrees of appraisal lag.

We examined current value or appraisal-based cap rates primarily in comparison to the interest rate on the 10-Year Treasury Note (10-Year). The spread between cap rates and the 10-Year reflects a complex relationship of not just recent appraisal valuations, but also future expectations for net operating income (NOI) and value growth. Lower spreads tend to be acceptable when there is potential for NOI growth in the quarters ahead and higher spreads are more appropriate when there is risk of flat or declining NOI.

Our research compares the current value cycle, from the value peak in the second quarter of 2022 through the first quarter of 2024, to the peak to trough value periods from the previous three cycles. The timeline of these cycles and magnitude of value declines are shown in the table to the right.

Cycle	Value Peak	Value Trough*	Quarters	Peak to Trough Value Decline*
Early 1990s	1989Q4	1995Q4	24	32.3%
Dot-com Bust	2001Q2	2003Q1	7	3.5%
Global Financial Crisis	2008Q1	2010Q1	8	31.5%
Current*	2022Q2	2024Q1	7	17.9%

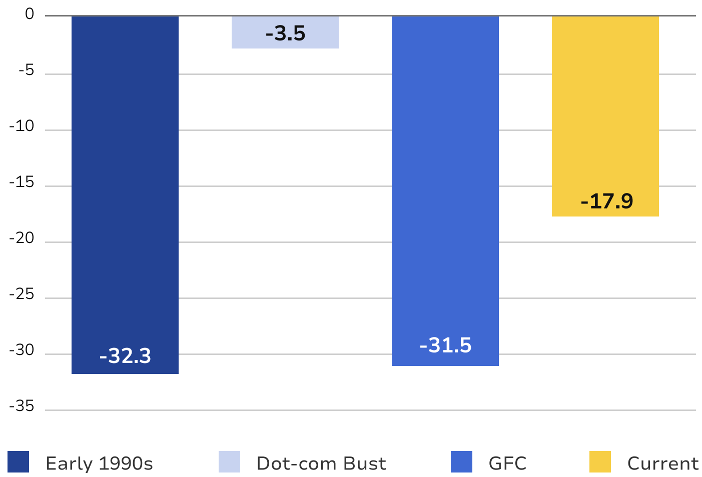
Source: NCREIF Property Index (Classic), Roofstock Research

* Current cycle is being measured through 2024Q1

[i] The NCREIF Property Index is an $832 billion benchmark for institutional private equity real estate reflecting performance of four main property types, industrial (35% of current index market capitalization), apartment (29%), office (22%), and retail (14%)

Property Values Have Fallen Significantly This Cycle Despite Continued Economic Growth

Peak to Trough* NCREIF Property Index Value Change (%)



Source: NCREIF Property Index (Classic), Roofstock Research

* Current cycle is being measured through 2024Q1

While not as severe as the early 1990s and Global Financial Crisis (GFC), where values declined by more than 30%, the drop in value this cycle has been significant given the strong economic and employment backdrop. This would seem to suggest that values may be on sale and that it is a good time to invest, but interest rate trends and relative yields tell a different story. The three prior value cycles came to an end aided by accommodative monetary policy and a favorable interest rate environment. The Fed Funds rate was reduced by an average of 300 basis points in those three cycles, as the Fed moved to improve liquidity, stem the decline in asset values, and encourage growth. So far in this cycle the Fed Funds rate has increased by 450 basis points. The Fed remains much more restrictive today than it was at the peak of property values in 2022.

Similarly, the interest rate on the 10-Year was lower or flat from the peak to trough in values in the three prior cycles. In the first quarter of 2024, the 10-Year was over 120 basis points higher than it was in mid-2022. A higher so-called "risk-free" rate implies that, all-else being equal, real estate investors should be seeking even higher yields on their investments to compensate them for risk. The higher prevailing interest rate environment also has knock-on effects for borrowers as the higher cost and lower availability of debt make it harder to buy new properties and refinance existing ones.

But more specific to our relative yield discussion, what happened to the spread between current value cap rates and the 10-Year in each of these cycles? In the chart on the following page, we see that this spread increased in the prior three cycles, making real estate look more attractive on a relative basis, while the spread this cycle has decreased from 2022 to today. By this measure, real estate looks less attractive today (the spread is lower) than it did at the peak.

In absolute terms, the contrast in relative yield is even more stark. The current value cap rate spread over the 10-Year averaged nearly 340 basis points during the Early 1990s, Dot-com Bust, and GFC cycles. This sizable spread helped draw in new capital and put a floor under values, setting the stage for future value growth. By comparison, the spread in the first quarter of 2024 was less than 50 basis points with the current value cap rate at 4.63% and the 10-Year averaging 4.16%. Not only is this a tight spread versus past cycle value troughs, it is also very tight for an asset class that has offered a 265 basis point spread over the 10-Year for the past 30 years. Real estate looks more expensive today than it has historically, and it is much more expensive on a relative basis in comparison to the value troughs of the prior three cycles.

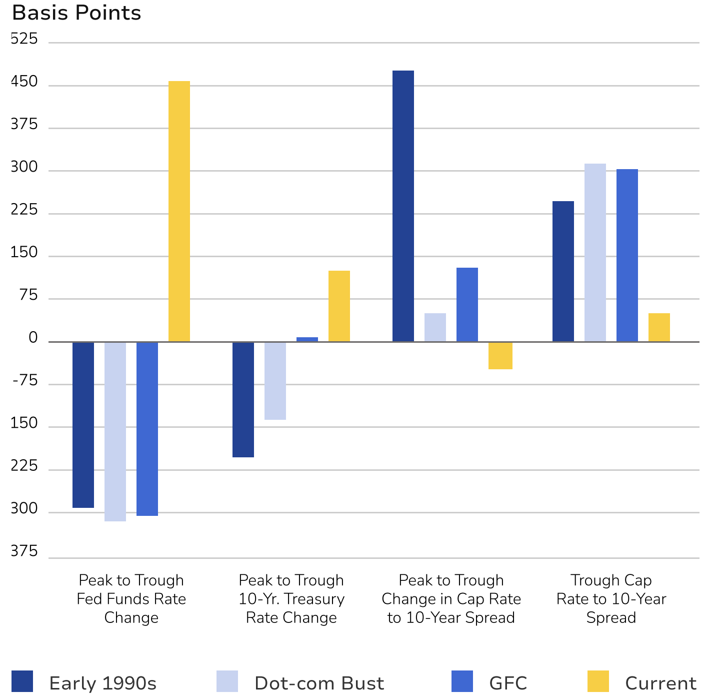
NCREIF data offer another perspective on values based on relative yields and that is derived from a comparison of transaction-based cap rates looking at the relatively small sample of properties sold from the index each period and the current value cap rate of the assets held in the portfolio. We do not want to overstate the precision of this comparison since the property sector and asset quality composition of sales in each period can significantly impact transaction-based cap rates in this small sample. Still, the spread between the two metrics is directionally instructive. These data tell us that properties are transacting at higher cap rates than book value would imply. The good news here is that properties can be acquired today at cap rates that are accretive to current portfolio yields.

This condition has been true over history with transaction-based cap rates running about 40 basis points over current value cap rates for the past 30 years. We have also seen that this spread tends to be even wider at cyclical value troughs. But today transaction-based cap rates are over 165 basis points higher than current value cap rates, the widest spread since the third quarter of 1992. A pessimistic view here would be that the value of held portfolios is more expensive today versus the transaction market than it typically has been. This is another signal that appraisal values may be too high.

Relative yield is just one part of the value story, and we are painting with broad strokes by looking at overall NPI trends. Property sector allocations, asset quality, and valuation processes are different from one portfolio to the next. Yields are undoubtedly more attractive and better supported in some property sectors and portfolios than others, although none of the major property sectors look attractively valued today versus past cycles.

The office property sector has the highest spread between current value cap rate and the 10-Year at 175 basis points as of the first quarter of 2024, but its spread averaged nearly 350 basis points at the trough

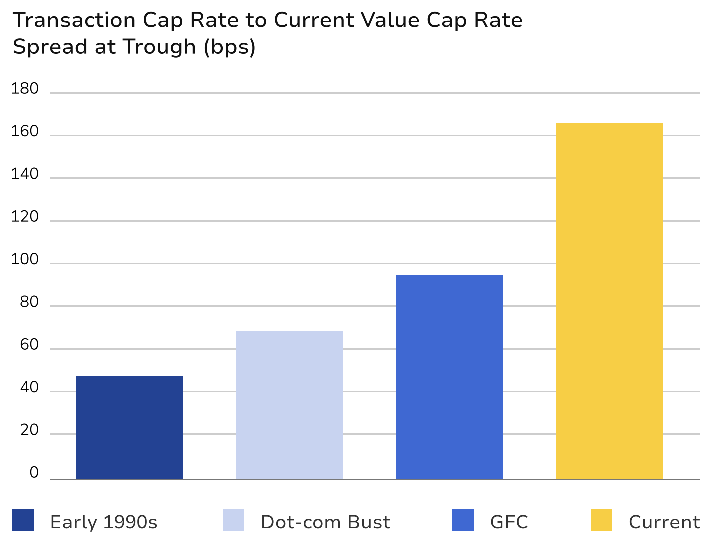
But Current Conditions Suggest Values May Fall Further



Source: NCREIF Property Index (Classic), Roofstock Research, Federal Reserve, Moody's Analytics

* Current cycle is being measured through 2024Q1

High Transaction Cap Rates Vs. Current Value Cap Rates Signal Either A Buying Opportunity Or Risk Of Depreciation



Source: NCREIF Property Index (Classic), Roofstock Research

* Current cycle is being measured through 2024Q1

of the previous three cycles and given the sector's heightened uncertainty due to changes in space utilization, it seems clear that office values have further to fall. Apartment and industrial assets in the NPI are held at current value cap rates in the low 4%-range offering, essentially no spread versus Treasuries. Fundamentals in these sectors are unquestionably stronger than office, but these holdings face valuation headwinds as well.

We will have more to share on single-family rental's (SFR's) role in a diversified portfolio in a future report, but this is a good moment to highlight that we expect SFR to enjoy strong tailwinds as demographics and affordability issues lead to more households seeking to rent single-family homes. The property sector is also materially undersupplied, setting the stage for healthy NOI growth. Additionally, even in this reduced home sales environment, there is much more clarity around property values in SFR than there is in the commercial property sectors. Transaction cap rates are similar to those in multifamily with fewer near-term supply headwinds and a more robust demand story. Institutions also own very little of this property sector, with exposure equal to less than 0.5% of holdings in the broader NPI universe, creating benefits from future capital inflows and opportunities to improve portfolio diversification.

Commercial property investors taking a bullish stance on rent and NOI growth driven by strong underlying economic conditions and reduced construction starts, along with expectations for the Fed to begin cutting rates later this year, may feel comfortable justifying tight current value cap rate spreads. In our assessment such positive perspectives may be too optimistic or at the very least fraught with considerable levels of risk. While recession probabilities remain low, around 25% per Moody's Analytics and Oxford Economics, the risk has ticked higher as tight monetary policy continues to flow through the economy. Monetary policy changes take time to unfold, and the same will be true when the Fed eventually begins to lower interest rates. The silver lining here is the Fed does have plenty of room to reduce rates if the economic environment deteriorates. But it is not clear that the long end of the interest rate curve will follow short-term interest rates lower in lockstep given the current inversion in the yield curve.

Second quarter NPI values may reflect stability and perhaps even a gain, but it is difficult to envision a concerted, material rise in property values given relative yields today. Making matters worse, interest rates were higher in the second quarter than they were in the first. The lack of a recession has been a significant counterweight to yield pressures. If a recession does occur, the downside risk is material with value losses from the 2022 peak potentially exceeding the 30%+ declines of the Early 1990s and GFC.

Investors with capital to deploy today on new acquisitions certainly have the opportunity to outperform the NPI benchmark as the book values of legacy assets slowly mark to market. But even these investors should carefully monitor downside risks and give strong consideration to property sectors with favorable supply and demand outlooks and, in the case of SFR, a sector where asset values are predominantly influenced by the housing needs and desires of individual owner-occupiers and not relative cap rate levels.

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