# Real Estate

As the Fed attempts to wrestle back control of runaway inflation through monetary policy, there are more implications for investors to consider across both commercial and residential property sectors. The primary impact of the Fed's recent rate hikes are the higher financing costs for investors and homeowners alike.

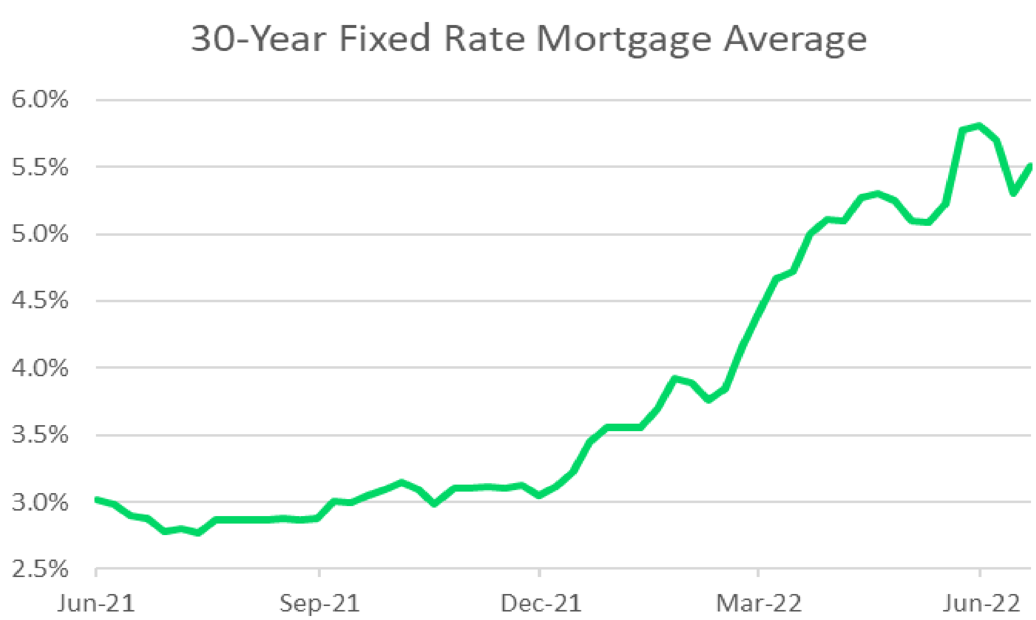
As a result, commercial real estate investors must reassess their business plans where the increased cost of leverage exceeds that of the going-in capitalization rate, creating a negative leverage effect that reduces short term profitability.

As we have discussed in prior research commentaries, real estate generally serves as a strong inflation hedge due to the supply constrained nature of the asset and ability to pass on price increases to tenants efficiently, depending on the lease term. Property types with shorter lease terms such as hotels (daily), self-storage (monthly), or multifamily (annually) will be able to reset their prices and efficiently pass inflation on to tenants in this environment. Office, industrial, and retail assets typically have lease terms of 5+ years and don't benefit from quicker re-pricing, but these leases usually have annual rent increases or CPI resets to absorb any inflationary pressure over the long term.

Certain property types, such as industrial and residential, have experienced strong value growth over recent years and now trade at 3-4% capitalization rates, exposing them to a greater impact from a leverage effect. Other sectors, such as office and retail, have 5-6% capitalization rates and provide more cushion for higher leverage costs.

In these situations, we have seen investors respond in two ways: (1) they can either pause new investment activity and wait for financing costs to ease, or (2) change their underwriting assumptions to justify new investments with the higher debt cost. The first scenario will create opportunities for investors with access to cheaper financing or unlevered investors as they will now face less competition. In the latter scenario, investors will likely need to increase rental growth assumptions, which can impact performance if assumptions are too aggressive.

Similarly to in the commercial sector, monetary policy has increased financing costs in the residential for-sale sector, as the average interest rate on a Fannie Mae 30-year fixed rate mortgage reached levels not seen since 2008 and has steadily grown over the last 6 months.




Source: RockCreek, Freddie Mac

As discussed last quarter, demand has outpaced the supply of single-family homes for sale, which has continued to push home values higher. Higher financing costs have impacted affordability, leading to the decrease of potential buyers for new homes - where there may have 10 buyers for a new home, now there maybe only half that today.  Escalating the situation is the fact that roughly 80% of existing mortgages are below 4% fixed rates, which make it that much more expensive for existing homeowners to sell and get a new mortgage. As a result, we expect to see slowing new home sales velocity and potential value declines on a year over year basis in certain further out submarkets. While the headline numbers may look troubling, there is still massive demand for new homes, and a reset will be healthy in certain submarkets as the Fed looks to combat runaway inflation.

As we continue to assess the industry and opportunities in this uncertain financing environment, existing multi-family assets with leverage in place and particularly single-family rental assets should have more room for growth and value appreciation, as owning has gotten to get more expensive relative to renting a home for potential buyers. Another theme we are evaluating is the net lease market where corporates may look to monetize their real estate as an alternative source of financing given traditional public credit methods have shut down. We are also excited about opportunities in other asset classes, such as logistics and digital real assets, to ensure there is adequate cushion between our cost basis and the new leverage costs and our ability to increase value.