YARDI® Matrix

EFFECT OF RISING RATES

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How Will Rising Interest Rates Impact Property Values?

Interest rates have remained at historical lows for four years, contributing to a bull run for commercial properties. With assets being traded at record low yields, especially in core markets, values have risen well above 2007 peaks in many segments.

The underlying question during this time has been what will happen to property yields (or capitalization rates) when interest rates rise? The question has largely been academic in recent years, as Federal Reserve policy and the drop in global goods and commodities prices have served to keep rates low. However, the 10-year Treasury rate—the benchmark used for multifamily borrowing—increased 65 basis points in the weeks following the election due to slowly accelerating economic growth, the prospect for more robust domestic output during President-elect Trump's administration, and the potential for reduced oil production.

Now that higher rates are here, what will happen with property yields? Certainly, higher long-term interest rates have the potential to be a headwind for the industry. The overall impact, however, will depend on a variety of factors that include how much and how quickly rates rise, and the performance of property fundamentals, since rent growth mitigates the impact of higher interest rates.

Example 1: Class B Dallas Multifamily

In order to calculate the likely impact, Yardi® Matrix did a series of calculations on hypothetical properties using multiple variables that include property revenue, expenses and the level of debt and debt service. Using Yardi® Matrix Expert, a proprietary data aggregation tool that allows users to see property expenses on a local level, we looked at the effect on values for specific properties as interest rates rise.

For our first example, we use a 300-unit, Class B apartment property in Dallas. As listed in figure 1, our initial cap rate assumption was 5.5%, which produced a value of $26.0 million based on net cash flow of $480,999. The property carries a mortgage of 65% of property value with a rate of 3.8%, which is the pre-election 10-year Treasury yield of 1.8% plus a 200-basis-point spread.