Hamilton Lane®

2022 Real Assets Market Oveview

Real Estate: Macro Environment

July 2022 | Scott Davies, Principal, Real Assets

“Real estate is well positioned in the face of rising interest rates”

Real estate investors around the globe have been reassuring themselves of this statement for decades; and indeed, at no time has this statement been more relevant than right now. And yet, some investors are still jittery. So let’s turn to some insights we’ve seen and heard throughout 2022 to offer some perspective to attempt to assuage some of those concerns.

Reason for Concern

The S&P fell 8.8% in April, was relatively flat in May and fell 8.4% in June, officially entering bear market territory on June 13. The culprit? Rising interest rates and concerns over inflation. The yield on the benchmark 10-year Treasury note edged up to 2.914% on May 2, up from 1.94% on February 1 and remains just under 3% as of June 30 after briefly touching 3.5% in June. This increase is in stark contrast to the downward trajectory that the 10-year has experienced since 2006 and, we think, the root of much of the fear surrounding real estate in the near term.

The Fear

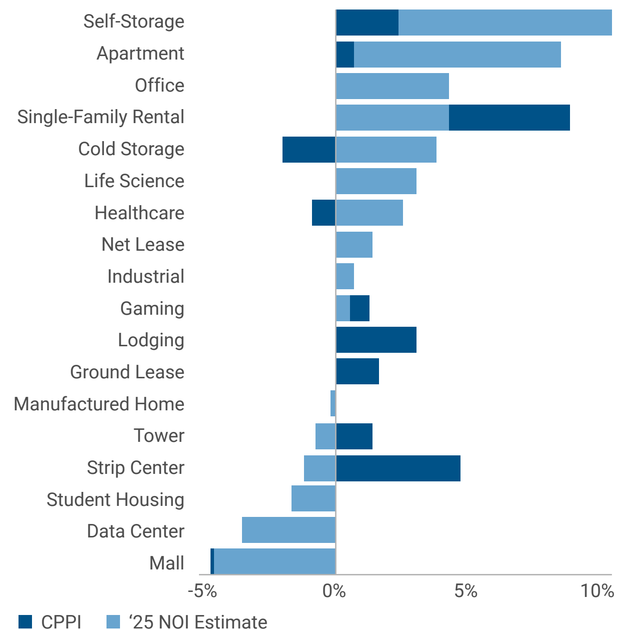
Rising rates means higher debt service costs which means higher required equity ratios (to keep lender-required debt service coverage ratios constant). In theory, and assuming all else remains constant, this should lead to lower go-forward returns from real estate (unless, of course, we can continue to produce all-time rental growth).

Let's Cut to the Chase

Yes, lower returns would be bad for real estate as a whole. But at this point, we continue to see strong fundamentals in terms of tenant demand, positive absorption and healthy investor activity that is fueling performance in specific sectors of the market. While market headwinds are real, we believe this demand will continue, proving that real estate is more resilient than the naysayers will tell you.

Despite the turbulence in the public markets, the conflict in Ukraine and a pandemic we just can't seem to kick, demand for many real estate property types has stayed exceptionally strong from a user perspective, leading to record low vacancy rates across several property types. These property types are experiencing an environment in which demand is outpacing supply and the weight of capital chasing these sectors is exceptional. We have seen year-over-year net operating income growth in apartments, for example, that reached all-time highs of over 20% in 2021 and rent growth that surpassed prior year annual projections in just a few months. This performance cannot continue, and there are signs in the market that cap rates and rent growth are softening. However, at this point, we see this correction as a reversion to long-term averages rather than a financial crisis that we experienced in 2008. Net operating income growth, particularly in apartments and industrial, has been a result of steady movement of individual and corporations to tax-friendly, high-quality-of-life markets. We believe this is a deep-rooted phenomenon and one that we expect to continue. Green Street predicts annual net operating income growth for the next four years will range between 3-7% in Hamilton Lane's high-conviction themes of healthcare, apartments, life science, storage and industrial sectors. Relative to long-term averages, these are very strong growth projections and this type of performance is sure to be welcomed by the investor community.

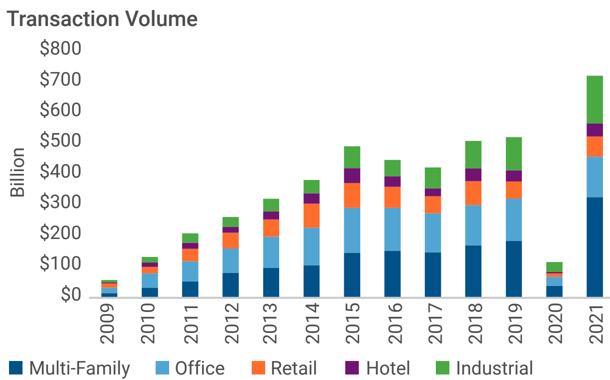
Changes to '25 NOI Estimate & Property Prices Since December



Source: Green Street as of March 2022

And Then There's Buyer Demand

Annual commercial real estate transaction volume crossed $700 billion for the first time ever in 2021, and steady transaction volume continued into Q1 2022. However, we are seeing a cooling of transaction volume in Q2, which is a sign that interest rates are proving to be problematic in the underwriting of real estate. The question we keep asking ourselves is whether the strongest performers will continue to attract the bulk of investor capital, or instead if investors will start to rotate to the out-of-favor property types to achieve higher yields and a lower basis. Ultimately the answer will be a combination of both, in that the majority of capital flows will steer towards sectors that exhibit strong fundamentals; however, a return to "opportunistic" investing will also return to feast on a word we have not heard in a while….distress.



Source: Bloomberg as of December 31, 2021

So, how do you position yourself among the winners?

One-year performance of the NCREIF Property Index as of Q1 2022 reached historic levels at 21.87%. And as we noted, this performance cannot continue. However, remember that real estate performance should revert to long-term performance levels instead of a repeat of the GFC because of healthy existing fundamentals, user demand and investor appetite. But one thing is for certain: Investors will have to work harder to achieve returns and cannot rely on cap rate compression to produce underwritten returns. Now more than ever, basis matters, manager selection matters, underwriting assumptions matter and deployment discipline matters. At the end of the day, real estate is an investment type with multiple levers to increase revenues and decrease expenses at the operator's disposal, and the best will find ways to extract value where others can't, regardless of the point in the cycle and headwinds in play.

Our own real estate investment strategy revolves around targeting themes that include shorter weighted-average lease terms, particularly in high-demand locations enabling the resetting of rents to offset inflationary pressures. We recommend property types that are less dependent on labor (storage, industrial, apartments), which is one of the more inflation-exposed expenses in a P&L statement. While we still prefer the property types that continue to see high levels of user demand, we also plan to keep an eye on traditional property types that historically achieve higher income yields, including retail, office and hospitality. We expect attractive opportunities to arise within these property types, where adroit investors can acquire stabilized, high-quality assets at 20%+ price discounts to prior transaction levels. We expect these opportunities to include central business district office, urban business hotels and regional retail facilities that may be stressed at the asset level or at the fund/investor level.

Lastly, we recommend knowing your operating partners, your leasing team, your asset managers and your property managers. It is critically important in these times of volatility to have good partners with a true informational advantage and operational expertise that result in sober assessments of supply, demand, competition and trends in their respective markets. These are trends that can outlast any market cycle.

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