

Why Commercial Real Estate Cost of Capital Just Became Stubbornly More Expensive

Dear Clients & Colleagues –

Unlike prior financial and commercial real estate crises, COVID-19 has wreaked havoc on the CRE markets in ways virtually no market participants had ever considered. AIRE's 2019 CRE Outlook surveyed thousands of market participants, and their greatest concerns about risks in real estate from a broader economic downturn were: Interest Rates (18%), Geographic Risk (16%), Trade Disputes (13%), Decline in Rents/Occupancy (13%), Oversupply of Space (12%), Decline in Cross-Border Capital Flows (12%), Decline in US Investing (10%), and Climate Change (5%). No one was considering what impact a Pandemic could have on Economic and CRE market conditions.

Such a “black swan” occurrence will have an incredibly outsized impact on the collective psyche of commercial real estate investors for the foreseeable future. The reason for this is multi-faceted. First, past downturns have all been reasonably predictable, often with the benefit of hindsight, but investors can look back at those events, and project forward their ability to underwrite the risk in the future. The lesson of the Great Depression was mortgage structures, and unregulated markets. The Great Recession showed the risks in overleverage and complex financial instruments. Even 9/11 was viewed in the context of terrorism which had been mounting for years and was understood as the need for more aggressive protection both domestically and abroad.

The problem with COVID-19, is that virtually no one did, or could have seen this coming (setting aside Bill Gates' TED Talk in March 2015). That fact will cause investors to take an outsized underwriting of future (and currently unforeseeable) “black swan” risks. Because such risks are inherently unlikely, and not easily forecast, investors will only be left with one route to account for them, and that is a wholesale increase in the average cost of capital invested into real estate.

What does that mean? First off, the Weighted Average Cost of Capital is composed of both debt and equity invested into real estate projects. Our view is that both lenders and investors are going to materially tighten their underwriting and pricing standards over the next five-plus years, which will cause a wholesale increase in the prevailing price of commercial real estate assets to the magnitude of as much as 100bps. Its important to distinguish this from the more short-term risk premiums that will be priced in from COVID-19's economic fallout. The combined impact of these two could push cap rates higher over the next 12-24 months by as much as 200bps.

Obviously, this movement in pricing will not be spread evenly; industrial and in particular, warehouse distribution, is likely going to be hit far less than hotels and retail. Yet, investors will be looking over their shoulders for the long-term, seeking to identify risk factors that may lurk outside their view and keep them awake at night.

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