


# OPERATING UNDER THE THREAT OF RISING INTEREST RATES

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## OPERATING UNDER THE THREAT OF HIGHER INTEREST RATES

- ◆ Novare Group is in the multifamily business producing entry level condominium product.
- ◆ Product can pro forma as apartments, which is a key risk control measure relating to the topic at hand.

# OPERATING UNDER THE THREAT OF HIGHER INTEREST RATES

- ◆ Before we get started, two points
  - All of the things we will talk about should be done at all times, not just times of seemingly imminent interest rate increases.
  - If we chose to do nothing and to stop producing and consuming due to the threat of higher rates, and everyone else did too, we would very quickly eliminate the threat.

# OPERATING UNDER THE THREAT OF HIGHER INTEREST RATES

## ◆ INTEREST AS A FIXED COST

- On the operating side of our business, i.e. the manufacturing or construction side, it means that we have to have a higher gross margin to cover the increased fixed expense. We solve that in the pro forma. We must and do assume that reasonable increases occur. This is no different from architectural fees going up.

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## ◆ INTEREST AS A FIXED COST

- The point is that it is certainly not construction interest that anyone is worried about, since the increase in rates would not have a debilitating effect on any project.
  - ◆  $(75\% \times 1\% \times 2\% = 1.5\%$  increase in cost)
  - ◆ Hedges, collars, swaps
- It is the effect that interest has on the long term financing of the asset by the ultimate purchaser that is the issue.

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- ◆ In our business, the concern is that
  - The purchasers of the condominiums would not be able to afford to buy the homes.
  - In the apartment scenario, the concern is that cap rates will go up with interest rates, resulting in new and existing apartment communities becoming worth less than construction or acquisition costs. This is primarily a concern with assets that are financed with short term debt, but in the longer term, the concern is with the residual. Like most human beings, real estate investors are less concerned with the latter ten year potential problem and more with the former short term problem.

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- ◆ Key historical difference between coming out of this slow period and coming out of the 1990-1992 recession the time that we came out of the last one is that apartment capitalization rates have adjusted down significantly to reflect the very low historical interest rates.
- ◆ This has offset very weak underlying NOI performance.
- ◆ So oddly enough, more people (or more probably the same number of people) are worried now that the economy is improving than when it started faltering.
- ◆ They are worried that interest rates will increase, but they are not assuming that rent and NOI performance will.

# OPERATING UNDER THE THREAT OF HIGHER INTEREST RATES

- ◆ Why might this not be a problem?
  - Condominium side of things
    - ◆ Rates are so low that there is time to exit before they get so high that purchasers can't buy.
    - ◆ The existence of strong variable rate home mortgage products provides even more runway to exit.
    - ◆ Greater threat to the entry level condominium market is a decline in jobs, which usually accompanies a drop in rates as opposed to an increase in rates.

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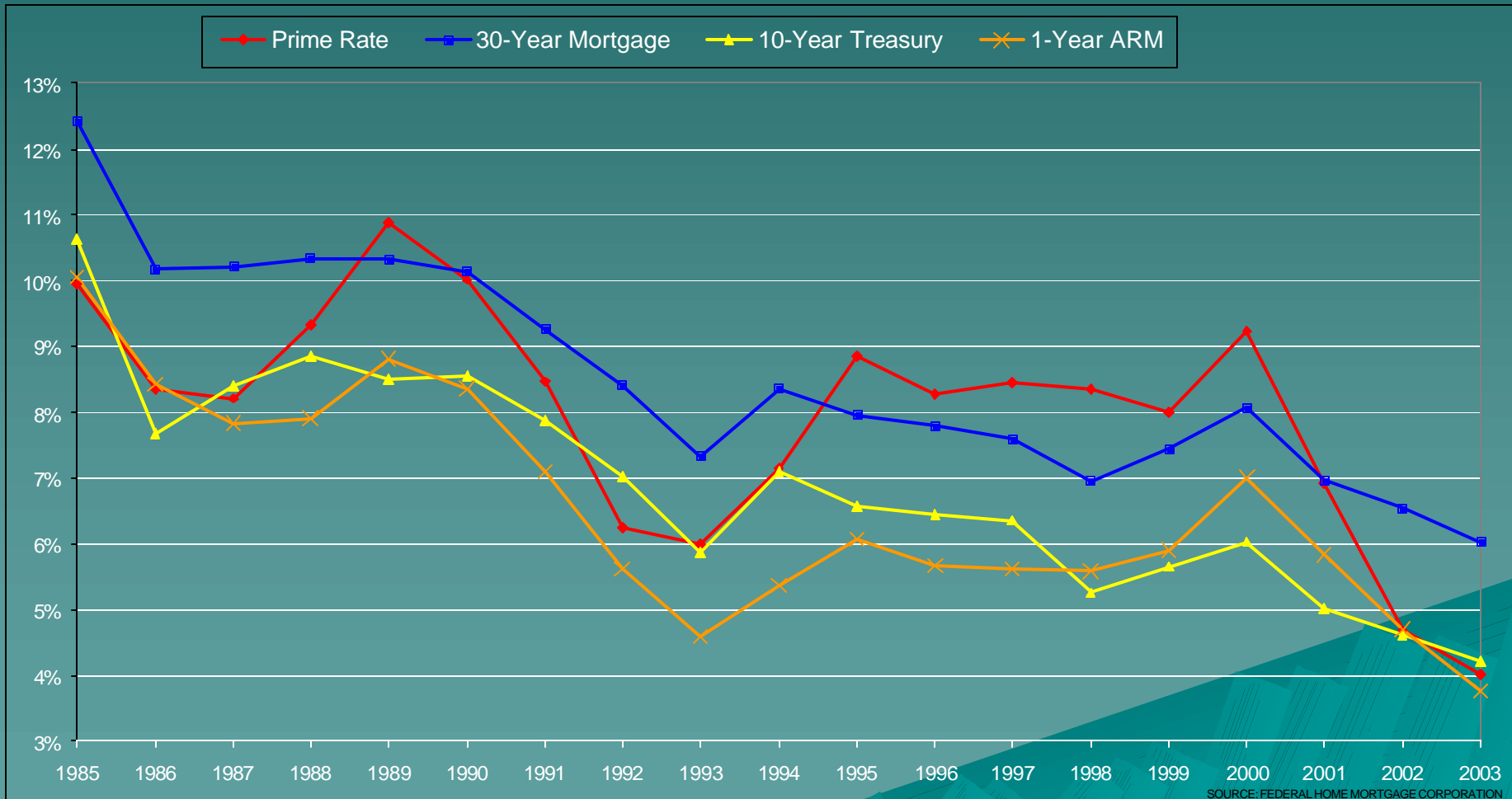
- ◆ Why might this not be a problem?
  - Apartment side of things
    - ◆ Asset could already be financed with long term debt, so under this scenario, with rents increasing as a result of an improved economy, this owner is happy for the time being.
    - ◆ Rents could rise with improved economy, increasing NOI at the same time cap rates increase. It is somewhat critical that the interest rate increases are accompanied by job growth – stagflation is not what anyone is looking for.
    - ◆ Do not assume that cap rates will skyrocket, although it is hard to imagine cap rates less than 200 basis points over the ten year treasury. There is actually a study (The Journal of Real Estate Research, Mueller & Pauley, 1995) that says that Equity REITS are not sensitive to interest rate increases, but they are sensitive to declines. Go figure. (Authors said more study needed)

## OPERATING UNDER THE THREAT OF HIGHER INTEREST RATES

- ◆ Difference between now and 1992 is that now rates are really, really low.
- ◆ Since 1985 – Prime, 1 Year ARM, 30 year mortgage, 10 year treasury

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Interest Rates: 1985 – 2003



# OPERATING UNDER THE THREAT OF HIGHER INTEREST RATES

## ◆ What can you do?

- Execute faster and deliver closer to the present
  - ◆ Pay for faster delivery
  - ◆ More marketing so you can have more pre-sales when you deliver
- Focus on improving margins and controlling costs. If your product is not producing a good margin now, and it is possible that prices may fall, you might want to re-think the product
- Your bigger issue is probably supply and demand, so be sure that everyone who has not been building is not going to start all at once.

# OPERATING UNDER THE THREAT OF HIGHER INTEREST RATES

## – What can you do?

- ◆ As an apartment, you can obviously lock in a fixed rate. But if your economics are not good, this may not be possible, so you may have to wait. Unfortunately, then rates will be higher under our assumptions. That is the trap.
- ◆ Hedge – But you will have to be smarter than the bond market, off of which these instruments are priced, and this is only a short term solution.
- ◆ For condominiums, it is difficult to buy forward commitments of home mortgage loans because the underwriting process can be subjective.
- ◆ What you can do instead, subject to FNMA limits, is to reserve some funds to buy down the rate of purchasers. Generally, they still have to qualify at the higher rates, but this helps at the margin.
- ◆ Make sure your lender has good variable rate programs.
- ◆ If rates rise too rapidly, be ready to “go apartment.” But don’t try to do this as a strategy halfway through a sell-out. Once you start selling as condominiums, wrap it up quickly. With that, I will do the same.