BlueRockPartners
Commercial Real Estate Advisors

NEWSLETTER

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Interest Rate Recalibration

The interest rate in the United States descended into the Great Recession back in 2008 & 2009 like many other precipitously falling items but, while many of the market elements have resumed pre-recession levels, interest rates have lagged considerably.

For the last handful of years a prevalent question in the capital markets is when are interest rates going to get back to historically "normal" levels. But the definition of normal interest rate levels for the U.S. has started to shift with an increasing number of sectors promoting the narrative that current levels may be much closer to the "new norm" than what many originally thought before the Great Recession.

The chatter surrounding this theory has increased significantly in the past two years with mentions being made by the major brokerage houses, the Federal Reserve and a variety of politicians. Much of the rhetoric is based on U.S. interest rates being relative to rates around the world amongst other stabilized economies (see chart on back page). Clearly the topic of national interest rate levels for any country touches on many affiliated subjects like the bond markets, national debt, deflationary concerns, etc.

There is a whole article that could be devoted purely to that topic, but the primary focus of this piece is how this could impact the commercial real estate market – especially in Hawaii.

Cap rates in Hawaii have typically run 2%-3% lower than most of the mainland markets for decades so the seasoned investors in our state have become conditioned to be comfortable with these lower returns. This is largely due to the tradeoff they get for Hawaii's relative investment security which has been proven repeatedly in various global market cycles.

So on the assumption that interest rates may hover at these levels for a prolonged period of time and cap rates in Hawaii also continue to linger at a similar range, where do investors go for more attractive returns? Development and existing businesses may be two good alternatives. We ran an article about 18 months ago on the increase in investment activity within the existing business realms and we continue to see that trend intact, but let's focus on the development angle.

Development has long been its own slice of the investment pie and for good cause – not everyone is wired for the expertise and risk required. Of course this is somewhat offset by the yields success can bring with 18%-22% return minimums and sometimes quite a bit better if things go well.

The disparity between cap rates on existing cash flow (5%) versus development ROI (20%) creates a chasm that is starting to become compelling for investment dollars that are increasingly less enamored with lower yield alternatives.

In Hawaii, we are starting to see lesser-experienced developers enter the arena, tenants beginning to self-develop and investors dabbling beyond their traditional asset profiles. Certainly there are those who continue within their core competencies, but there is no shortage of creativity and willingness to consider approaches outside of historical norms.

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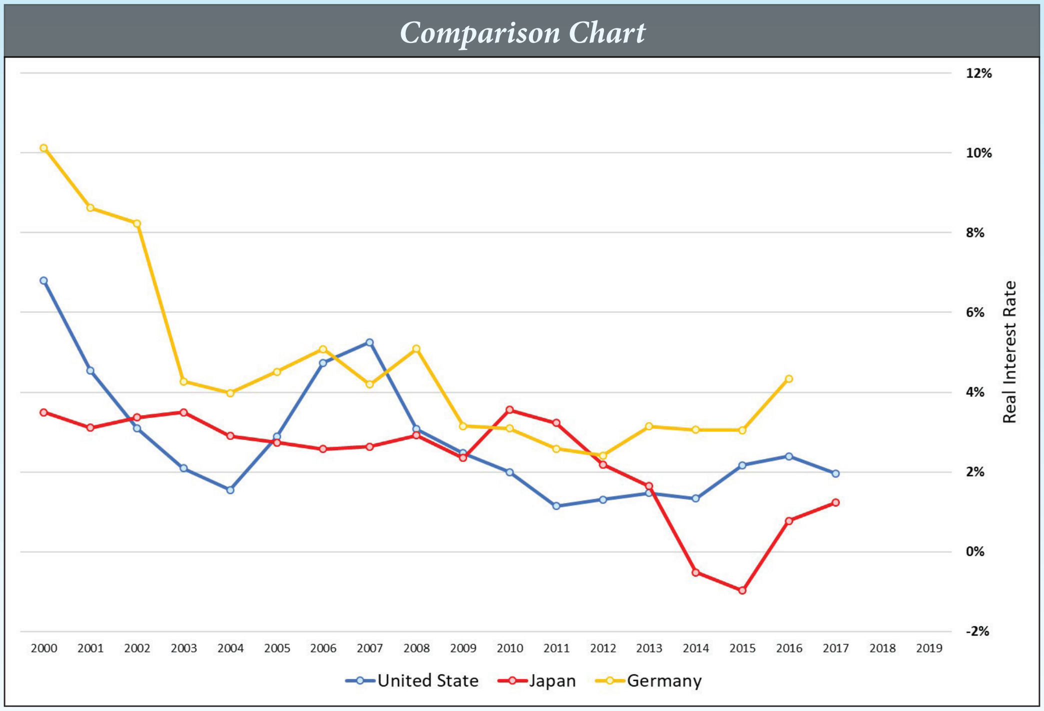
While this shift is interesting and will likely change some of our market's dynamics, it clearly comes with an obvious risk as investors delve into unfamiliar realms. It is possible, and even likely, there will be complications during the learning curve of this transition, but all a part of the foreseeable growing pains that come with a market shift.

The relative safety of Hawaii's inherent real estate value has likely emboldened these decisions, but if the interest rate recalibrates itself to a significantly lower range, we expect to see more of this investor behavior.



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