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A look forward to more normalcy in 2022 - by John Rynne

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In my last NYREJ article in November, I wrote about slightly rising overall capitalization rates indirectly driven by anticipated increased rates by the Federal Reserve. The more direct driver of overall capitalization rates is mortgage rates instituted by individual lenders which generally set their interest rates many times to 10-year treasuries issued by the Federal Reserve. These rates usually are based upon a formula of 200-400 basis points above the 10-year treasuries in the most recent markets. Typically residential mortgages are at the low end and commercial mortgages are at the higher end of the basis point spectrum because of risk. In general, residential mortgages are viewed as less risky than commercial mortgages.

It's common knowledge in the appraisal field that overall capitalization rates move very slowly in response to mortgage rate changes. While mortgage rates go up and down, overall capitalization rates go up and down on a more delayed basis at only a fraction of the changes in mortgage interest rates. That's because the treasury bond and mortgage securities market are very liquid, whereas real estate properties are not. Commercial properties have a general marketing time of 3-12 months with closing dates that drag it out even further because of financing requirements, property condition reporting, environmental reports, buyer remorse, etc. In my November article, 10-year treasuries were at a level of 1.45%. As of February 4th the 10-year treasury was at 1.93%; almost a 33% increase. If the same increase was applied to Rynne, Murphy & Associates, Inc. (RMA) 4th Quarter 2021 suburban apartment overall capitalization rate average of 6.25%; the adjusted rate would be over 8.31% which is not realistic. It's unlikely the overall cap rate increase will be any more than 6.5%. Please note that the RMA rate survey applies generally to Upstate New York and west central New England.

The primary reason for the rate increases driven by the Federal Reserve is the concern of inflation which is on pace to be the highest level in 40 years. The supply chain problems created by the hangover of the COVID lock downs are real. As an example, many apartment project owners large and small cannot get reasonably priced appliances unless they are placed upon a multi monthly waiting list. The Rochester Cadillac dealer where I've been buying cars since 1985 has an empty showroom. Two months ago there was one car in the showroom and that was a used 2019 Cadillac with 15,000 miles at a sticker price of $62,000. That car sold quickly. Reportedly, the Cadillac production line won't be back to normal until 2023 at the earliest. Throughout most of Upstate many of the new cars have already been spoken for off the assembly line. Thus, the inventory on the car lots remain extremely low and consist primarily of used cars. The average price of a used car according to Buffalo NADA increased over 19% from 2020. This type of inflationary pressure has also applied to food, gasoline, natural gas, other utilities, labor, etc. Of course all this has a huge inflationary effect on building costs which is responsible not only for new construction but also existing real estate.

So the continuation of low interest rates and increased building costs have resulted in escalating real estate prices. As an example, a 10-year-old 222-unit apartment complex in the Albany area known as the Waters View Apts recently sold for reportedly $46 million or $207,207 per unit. In Saratoga Springs, The Pavilion Grand Executive Apartments, a 53-unit apartment, hotel and small retail complex sold for $24 million or $452,830 per unit. The Hamlet at Saratoga Springs, an 145-unit apartment and extended stay project, recently sold for $56.5 million or $389,655 per unit. The city of Buffalo recently approved the sale of a 0.90 acre site for $1.5 million or $38.26 per s/f or $1.666 million per acre. This parcel will be the site for a proposed $46 million, nine-story, 148-unit apartment complex. The projected cost with land will be $310,811 per unit. In suburban Rochester, there was a sale on West Ridge Rd. of a 0.58 acre corner site for $1.425 million. The price was $2.457 million per acre or $56.86 per s/f in 2019, which was before the COVID crisis. On a smaller scale, an old 18-unit apartment project in the city of Rochester sold for 504% more than it did 29 years ago, which represents a 17.39% annual average increase or 6.40% annual increase if compounded. A single-family suburban house which was listed for near $500,000 sold for almost 25% over asking price. The average SP to list price of single family in the Rochester Region has been approximately 8%. These are examples of what low interest rates, low inventory and escalating construction costs in the marketplace can do. However, there are some property types which have not performed well including office and retail mall properties.

In summary, 2022 may be more of the same that transpired in 2021. Although increasing mortgage rates will dampen value, COVID herd immunity will create more normalcy which will stabilize any negative influence of rising interest rates.

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