Valuation Hot Topics in an Ever-Changing Landscape

How have capitalization rates changed over the past 12 months of rising inflation? Michael Novogradac, CPA, and Novogradac partner Lindsey Sutton discuss the effects of high inflation on observed market capitalization rates, as well as long-term debt financing.

Summaries of each topic:

Transcript

[00:00:11] **Michael Novogradac, CPA:** Hello. I'm Michael Novogradac. And this is Tax Credit Tuesday. This is the June 28th, 2022, podcast. In this week's podcast, we're going to discuss the effects of inflation on the valuation and long-term financing of low-income housing tax credit properties. I recently wrote about the topic of inflation in housing tax credit properties in my monthly Journal of Tax Credits Washington Wire column.

And it is a topic I spoke about last week in Chicago at the National Council of State Housing Agency's Credit Connect Conference. This is also a topic we're sure to touch upon this fall in Novogradac's affordable housing tax credit conferences. This is a particularly important and timely topic because we are experiencing levels of inflation never before experienced by the housing tax credit community.

The annual rate of inflation last month, May of 2022, was 8.6%. That is significantly higher, over 50% higher, than any inflation rate experienced since the low-income housing tax credit was created. The 8.6% rate is more than double the annual inflation rate for any year from 1990 to 2020. From a new development perspective, such a high inflation rate obviously drives up construction costs, but it also affects the various sources of affordable housing financing.

Some effects are positive, many are negative. For existing properties, a high inflation rate increases, rather quickly, many operating expenses. Income levels rise, but on a more delayed basis as family incomes rise and HUD releases their annual area median income estimates.

In some ways today's podcast is a follow up to a previous one. In the March 1 episode of Tax Credit Tuesday, my partner Blair Kincer and I discussed how inflation was affecting low-income housing tax credit financing, development and operations.

Today's podcast takes a step back from looking at the effects of inflation on individual properties and looks at the effects of high inflation on observed market capitalization rates, as well as long-term debt financing. More specifically, we'll talk about how the capitalization rates have changed over the past 12 months during a period of rising inflation.

Joining me in today's podcast is my partner Lindsey Sutton from Novogradac's Valuation group in the Austin, Texas, office. Lindsey specializes in market analysis and appraisal services. She provides these and other consulting services to syndicators, developers and lenders. She also has extensive experience working with Fannie Mae and Fred Mac. So if you're ready, let's get started.

Lindsey, welcome to Tax Credit Tuesday.

[00:03:00] **Lindsey Sutton:** Thank you, Mike. How are you?

[00:03:02] **Michael Novogradac, CPA:** I am very well. Thank you.

[00:03:03] **Lindsey Sutton:** Good, good.

Overview

[00:03:05] **Michael Novogradac, CPA:** So before we get started, if you could explain to our listeners what a capitalization rate is, how it's calculated and how it's used to estimate the value of a rental property.

[00:03:16] **Lindsey Sutton:** Sure. That's a really great place to start with our conversation. What we use capitalization rates for is we're converting the NOI of an income producing property into an indication of value. Typically the—

[00:03:28] **Michael Novogradac, CPA:** May I interrupt you? What is NOI for our listeners?

[00:03:31] **Lindsey Sutton:** Net operating income, sorry. Typically investors are using pro forma cap rates. They're going to include the higher rents of in-place rents or below market. They can include lower expenses if the operating expenses are actually lower than similar-typed assets in a market. So the easiest way to calculate the capitalization rate is taking your net operating income, a.k.a. NOI, and dividing it by the estimated value of the asset.

[00:03:59] **Michael Novogradac, CPA:** I guess it's akin to an interest rate on a bond. Would you say?

[00:04:04] **Lindsey Sutton:** Yes, it's a measure of risk is the best way to put it, too, for investors.

[00:04:11] **Michael Novogradac, CPA:** I think of capitalization rates as the yield you're getting on a property, similar to the yield you're getting on a bond. And then of course, capitalization rates change over time.

[00:04:23] **Lindsey Sutton:** They do.

[00:04:24] **Michael Novogradac, CPA:** As that operating income changes over time.

[00:04:26] **Lindsey Sutton:** Correct.

[00:04:27] **Michael Novogradac, CPA:** So, as I noted in the introduction, the rate of inflation last month, May of 2022, was 8.6%.

I still find it hard to say, cause that's such a high number. A year ago, in May of 2021, the rate of inflation, the annual rate of inflation was 5%. So the May of 2022 of 8.6% is a whopping 360 basis points higher than just a year ago. And 5% many think is fairly high as well. Now, many would think that in high inflation times, capitalization rates, the net operating income divided by the valuation of the property, that capitalization rate would rise as well such that property values would need to fall.

Now in the alternative, instead of looking at the inflation rate, you could look at the 10-year Treasury, the 10-year borrowing costs, on a level interest rate basis for the federal government. And the 10-year Treasury rate is 3.3% or so now, and a year ago it was half that about at 1.5, 2%, which means that over the last 12 months, the interest rate, the cost of borrowing by the federal government, which is considered obvious by many people as a risk-free rate of return, has risen 150 basis points.

So once again, if the cost of funds is rising, a layperson would think cap rates would also be rising. So I've just noted that inflation high inflation suggests cap rates should be rising. The cost of funds has been rising. That would suggest that cap rates should be rising. So tell me, what have you observed? How do cap rates today generally compare to cap rates a year ago?

Changing Cap Rates

[00:06:10] **Lindsey Sutton:** So we're in a much more unique situation I think we've ever actually seen. Currently, we're still seeing continued cap rate compression, which just means the cap rates are still declining and it's leading to the continued market values of increased market values for the multifamily properties.

And that can or cannot be without the direct correlation of increased rental income because of demand. Currently in most markets, we are seeing the cap rates still falling given the larger increases in NOI and the larger markets that are nationwide. But if we look at some markets where we have seen some pretty dramatic decreases in capitalization rates, even for affordable housing, not just market-rate housing. Looking into markets I work in like Naples, Florida, for example, we saw multifamily cap in late 2020, most of 2021, between 4.75% and 5.75%. Cap rates now, end of 2020, through 2021, let's go December to March 2022, we're seeing assets trading from 3.1 to 3.5% and actual sellers reporting 30% increases over the last six months in rent alone.

That’s really unheard of, and over a decade of doing this, I haven't seen that yet. Same thing I’ve seen LIHTC transactions in Florida, like Orlando, transferring at sub-4% capitalization rates, which is also pretty unheard of given there is a limit to your rent increases, which does limit your NOI potential there.

Orlando's the same thing. They're seeing decreases of around 75 basis points in these cap rates over the past year. So to make that more understandable. It's not just Florida. Let's compare it to California, right? California, historically, has always had the lower, some of the lowest cap rates in the country.

If we look at, I went back and I looked at some reports in San Jose. Back in 2021 assets were trading for, 4.25 to 4.75%. Early 2022, similar asset class, is trading between 3.5 and 4%. So, even though they're seeing a decrease, we're seeing actual cap rates in Florida, which are historically higher, actually begin to narrow and become more in line with California rates, which is, is pretty unheard of at least in these few markets.

Reasons for Cap Rates Changes

[00:08:19] **Michael Novogradac, CPA:** So, it seems, like I said in the introduction to the question, almost seems counterintuitive that cap rates would be falling when you have high inflation and rising interest rates. What are some of the reasons that you attribute the cap rates falling?

[00:08:37] **Lindsey Sutton:** It is counterintuitive, actually, given you wouldn't think it would correlate that way. The biggest thing is going to be the historical price increases in the multi-family assets. And the increased demand for the same assets given the pandemic and everything. So even though the interest rates are increasing, so are mortgage rates for the general population and housing prices.

And that's continuing to drive demand for rental units, which is going to give greater potential for increasing NOI in rents. And even though interest rates do affect the multifamily cap rates, drivers like the improving NOI will continue to keep those cap rates a little bit lower.

So, another example is like an Austin rental market. The rent growth in 2021 was the highest historical ever recorded, at 14% rent growth. So you look at those compared to other top-30 metros, which were a little bit higher than 20%. It's just, we're all breaking a lot of records. So even though you have inflation that's going through the roof and you have interest rates creeping up the demand and the increase in NOI is offsetting that. So it's allowing those cap rates to still remain a little lower.

[00:9:46] **Michael Novogradac, CPA:** And I guess that just shows how my comparison of a cap rate to an interest rate on a bond might be true year one. Or if the projection projected net operating income was achieved, but then year two, year three, year four, the net operating income is expected to grow. So it's still like a bond that would be going at 3.25, then maybe 3.5, and then slowly kind of rising.

[00:10:10] **Lindsey Sutton:** Right.

[00:10:11] **Michael Novogradac, CPA:** So as the projections of net operating income over the next 10-plus years might be rising more rapidly. That can lead to sort of falling cap rates.

[00:10:23] **Lindsey Sutton:** Correct.

Cap Rates Predictions

[00:10:24] **Michael Novogradac, CPA:** So as you look forward, do you expect cap rates to continue to decline, expect them to flatten? Or do you think at, some point the cap rates will start to rise?

[00:10:38] **Lindsey Sutton:** Well, I've definitely been talking to some lenders and other real estate professionals, trying to get some kind of grasp on this. We had originally thought that cap rates would increase during the pandemic. Thinking it was the opposite, though, they compress and they continue to compress.

So it's kind of an unknown territory. But some of the discussions I've had with some lenders, they're still seeing steady declines in caps rates, not as large as they have been. And they do, even though the interest rates are increasing in cap rates, they're going to stabilize, they're going start to flatten out.

It's estimated let's say the interest rates as they continue to creep up the end of the third quarter of 2022. The biggest driver here is that there's still very, very huge demand out there that is kind of negating any increase right now on interest rates. But if the markets continue to see this historical rent growth that they've been seeing in the larger markets, you can see you can pretty much guarantee there's going to be some compression in those cap rates still, if not, just remaining steady where they are now. Freddie Mac is anticipating appreciation in 2022 as well for the rent. So I would say, fourth quarter, based on some of the lender conversations and they're thinking it's going to start to level out fourth quarter of 2022.

It may even go into the first quarter of 2023, though, but they will start creeping up since inflation continues to meet those historical high levels every time we note it.

[00:12:04] **Michael Novogradac, CPA:** Right. And there's been talk about the Fed continuing to raise interest rates. And there are many economists that are projecting the chance of a recession at the 80% level or something sort of higher. Any thoughts on the impact of the presumed likelihood or probability, but by many would say probability of a recession in the next year and the how that interacts with the cap rates?

[00:12:40] **Lindsey Sutton:** Absolutely. And especially if the Fed is going to raise it again with what they believe, 75 basis points in July, which is just going to lead to higher. If your key rate is that, then we can expect higher interest rates going up really fast, but I have been discussing with people and they believe that as the inflation continues to increase, inflation rates and your rising interest rates, it is impacting the economy and they believe there will be a recession, but it would be short lived, around a year or so.

And most people are noting it's because this is driven by more atypical factors than historical. You had the pandemic and the response to the pandemic, which actually created the supply chain issues, and companies and individuals are much more adept to making adjustments, given what they've just gone through as well, that they should help to lead to the quicker than what you would normally see for recovery. But again, most people, if not all, believe in that affordable housing will see little to no direct impact due to recession since there's such strong demand, which will remain true even if a recession were to hit the economy as a whole.

And there's already short of affordable housing nationwide as it is.

Cost of Long-Term Permanent Financing

[00:13:44] **Michael Novogradac, CPA:** I liked your point about the companies having to be more adaptable in the course of the pandemic and how that can lead to quicker response during recession. So, excellent observation. So let's turn now to the cost of long-term permanent financing. So how have long term interest rates changed over the last 12 months?

I mentioned earlier how in the last 12 months, the 10-year Treasury has raised 150 basis points, but only the federal government can borrow based on the rate of the 10-year Treasury.

[00:14:18] **Lindsey Sutton:** Right.

[00:14:19] **Michael Novogradac, CPA:** So you how have you seen interest rates for borrowers changing over the last 12 months other than the federal government?

[00:14:27] **Lindsey Sutton:** The long-term rates are increasing over the past 12 months and it's due to the U.S. Treasury, but also because the investor spreads are widening over the same period. Long-term interest rates are made up of obviously the Treasury and your investor spread. So, the 10-year Treasury was, let's say 1.5% 12 months ago and is now 3.25. And the investor spread, let's say it's 1.25 and now it's 1.5. You're looking at a pretty big basis jump there, 150 to 200 bits, right, over a 12-month period alone, which also has not been what we've seen historically.

[00:15:08] **Michael Novogradac, CPA:** It is interesting when I think about the long-term interest rates being as a rise. Many tax-exempt bond developers or those that develop afford housing with private bonds would comment how the beneficial rate of private bonds isn't that much better than other financing. When interest rates are low, the value of the tax exemption isn't as great.

So as interest rates are rising it'll be interesting to watch how that beneficial rate of private-activity bonds starts to increase. And if we don't see more developers finding a stronger benefit of using tax-exempt bond financing on the debt side, beyond the obvious feature of bringing low-income housing tax credits to a property.

[00:16:03] **Lindsey Sutton:** Right, right.

[00:16:05] **Michael Novogradac, CPA:** So some tax credit owners like to use variable rate financing and then they end up also having or buying interest rate caps to protect their tax credit investors from a spike in short-term rates. To what extent are investors and owners moving away from variable rate financing in your experience, variable rate financing with caps, given the current rise in short-term interest rates?

[00:16:29] **Lindsey Sutton:** So I have actually talked to some of my larger lenders and banks and seeing what they're seeing in the trends and the investors. And they are saying that most investors are moving away right now from the variable rate financing due to the cost of the interest rate cap.

We looked 12 months ago at the cost of a three-year cap was around let's say 3%, with a 20 basis points of the loan amount. And today it's 250 basis points. So if you're looking at a $10 million loan, the cap was approximately $25,000 compared to what it would cost today of $250,000. So you're looking at these interest rate caps costs increasing tenfold in just a 12-month period.

And I guess the only time that you're still seeing the variable rate financing being used right now, which some people will still do it, but more commonly you’re going see it with short-term bridge loans. When they're converting to permanent fixed rate financing, before they were actually lenders and or investors were using this as a long-term financing strategy because the cost was so much lower to buy that interest rate cap.

[00:17:29] **Michael Novogradac, CPA:** And in your experience, would you generally see the use of financing more with productivity bonds than with long-term, non-tax exempt debt for allocated credit finance properties?

[00:17:44] **Lindsey Sutton:** I personally see it more in the bonds. And so with my lenders, I guess everyone kind of does, but my own experience has seen it more in the bond market of it, seeing that's what they're using it for.

[00:17:56] **Michael Novogradac, CPA:** Yeah, which also makes sense because with private-activity contracts properties, since the credit percentage is lower, you're going have a lot more hard debt if you will, debt with required monthly payments.

[00:18:09] **Lindsey Sutton:** Right.

[00:18:10] **Michael Novogradac, CPA:** So the relative delta in terms of variable rate vs. fixed rate can be larger. And then obviously if, at this point in time, the cost of the caps is a lot larger.

[00:18:20] **Lindsey Sutton:** Yes, much larger.

[00:18:23] **Michael Novogradac, CPA:** So thank you, Lindsey. I appreciate you sharing your insights with us. Any last minute comments you wanted to make?

[00:18:29] **Lindsey Sutton:** No. I just think that it's interesting to see how the rest of the year's going to play out. We thought the pandemic was interesting and now we have an economic issue we're looking at and let's see how it all plays out. And if we're kind of going down the right trajectory here on our forecast, it'd be interesting.

[00:18:45] **Michael Novogradac, CPA:** Yeah. Interesting is exactly the right word. It'll have a lot of unexpected twist and turns.

[00:18:51] **Lindsey Sutton:** Yes, just be adaptable.

[00:18:54] **Michael Novogradac, CPA:** Look at the inflation rate and everyone talks about: is it transitory or not? And I like to look at it and think, well, we know parts of it have to be transitory.

[00:19:01] **Lindsey Sutton:** Right.

[00:19:02] **Michael Novogradac, CPA:** The question is how much of it is transitory, and how much is not. And then to what extent does the increase in the Fed funds rate lead to a soft landing as opposed to a hard landing? And if we do end up in a recession, as you point out, how long will the recession be and how a deep might it be?

[00:19:21] **Lindsey Sutton:** Right.

Exit

[00:19:23] **Michael Novogradac, CPA:** So thank you again for, joining us. Please, to our listeners, please be sure to tune into the next episode of Tax Credit Tuesday. You can make sure you're notified of that episode and each week's episode by following or subscribing to the Tax Credit Tuesday podcast.

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Off-Mike

Now I'm pleased to reach our Off-Mike where listeners can get some off topic advice and words of wisdom from our podcast guests.

So, Lindsey, the first question, which is, the question I'd like to ask guests, and since you're a first-time guest, I've not asked you this before: What's the best piece of career advice you've ever received?

[00:20:15] **Lindsey Sutton:** That's a good question. I have a lot of good people around me that have always provided really good advice, but one that sticks out is what my dad said is. He taught me to have the courage to speak up, whether it's to correct something that you see that's wrong, or just to ask the question to make sure that I'm clearly understanding a topic or what is being asked of me. It can be a little overwhelming and it can be scary, depending on your audience or who you're actually, speaking up to, nut it lays a foundation for like who I am and it establishes what I will and won't do. And it helps me understand what I don't know. I think that's a really big building block in learning how to effectively communicate with others. If you can learn that speaking up just to make yourself noticed or make yourself more educated has been very, very helpful to me.

[00:21:01] **Michael Novogradac, CPA:** Now that's great advice. Your father is a wise man.

[00:21:05] **Lindsey Sutton:** Yes, he is.

[00:21:07] **Michael Novogradac, CPA:** So another question that I also love to ask is what part of your daily routine that you do you most look forward to and why?

[00:21:18] **Lindsey Sutton:** It is funny because most people don't like to wake up early. I like waking up early. I wake up early for my cup of tea. It's the few minutes in my day that I have that I can actually enjoy my silence and I can catch up on reading if I'm reading a book or I can read some news or do a crossword, get it done before waking up my girls and starting the workday.

It just kind of keeps me fresh and ready to take on whatever life is ready to throw at me that day. And it's just something I always look forward to that alarm going off sometimes. Not always, but it's, it's nice to have that morning cup of tea, relax and get some personal time.

[00:21:54] **Michael Novogradac, CPA:** No, that's great. I enjoy getting up early as well. So what’s your favorite tea blend?

[00:22:00] **Lindsey Sutton:** I'm an Earl Grey fan, but I do like to go off and try some other, higher-caffeinated things. I don't drink coffee. I like to just have my tea and just that and a lemon. And I'm good for the day.

[00:22:15] **Michael Novogradac, CPA:** Good for you. So I'm a tea person as well, and have a little tea blend of yerba mate, which is a technically tea, green tea and pu-erh tea, a little three-part combination every morning. So I like it a lot.

[00:22:33] **Lindsey Sutton:** One time I tried to make my own tea bags. I would say we did not keep those very long, but I did try.

[00:22:43] **Michael Novogradac, CPA:** Good for you. So a third question. What's your favorite work-life balance tip?

[00:22:48] **Lindsey Sutton:** This is the ultimate question, right? Everybody wants to know.

[00:22:51] **Michael Novogradac, CPA:** Yes, it is. That's right. Everyone wants to know the answer here because none of us have enough work-life balance tips.

[00:22:59] **Lindsey Sutton:** I know we don't. But for me, it's just creating a schedule or routine. When I create that schedule or routine, it's not like every day, it's like I'm 8 to 5. Some weeks are different. Depends on different scheduling and what my commitments are and everything, but it actually helps me schedule commitments with my family and my friends and my kids in a streamlined manner instead of always having to check my calendar, let me check it. Or, even worse, is overcommitting, which is just going to cause me more stress. So, keeping a consistent routine helps me balance out the work that needs to be done. It pushes me to get it done because I am on a schedule and it allows me to be more present when I'm not working with my family and my kids and my friends.

It kind of just allows for me to plan for a week at a time on a continued schedule. And it just helps push you and you can base it on your workload. And if I have a really busy week, my schedule is going to be more leaning toward work. And then if it's a lighter week, then it'll be more towards my family and, and me time.

[00:23:55] **Michael Novogradac, CPA:** That's great advice. Thank you again, Lindsey, for joining us on Tax Credit Tuesday. To our listeners, I'm Mike Novogradac. Thanks for listening.

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