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The Rental Market Indicator

Fourth in a Series

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My last article outlined the bullish case for real estate valuation growth in the coming years. However, our rental market indicators portend a rocky road over the next few months.

Currently achievable rental rates for industrial, commercial and retail property are an excellent leading indicator of market strength. Each commercial property market cycle starts out with a high rental rate ratio to purchase price. This cycle tops out when rental income cannot support acquisition and carry costs of real estate ownership.

Like most economic analysis there is the danger of subjectivity, and the failure to properly weight the various contributing factors. In this cycle, the low cost of mortgage debt, optimistic expectations for continued asset appreciation, and zero income taxes on resale due to 1031 exchange rules has created the "perfect storm" for accelerating prices.

Ultimately however, the economic utility of the property must be supported by either a rent paying tenant or an owner-occupant selling a supportable level of widgets. This has not been a problem over the past few years because the cost of ownership has stayed reasonably level as stable rental rates and increasing operating costs have been matched by mortgage debt rate decreases.

Typical financing leverage of 75% loan-to-acquisition cost creates an ever-increasing positive leverage in a lowering rate environment. An example would be a 9.5% Cap Rate investment with a mortgage interest rate of 5.5%. The resulting equity dividend rate would be an exhilarating 20%. Every 50 basis point drop in the financing rate results in a 1.5% increase in the equity return. As long as occupancy rates remain stable, even a sharp jack-up in operating expenses shouldn't quell the upward push on valuations. Therefore, the bubble should continue to expand until interest rates increase and/or occupancy rates drop.

We may now be witnessing the beginnings of a perceptual shift as achievable rental rates are falling; shelf life is increasing, and operating expenses, due to fuel and real estate taxes are bumping up. The invisible ceiling to pricing growth will be slammed in place when the market recognizes interest rates have no where to go but up. While this dour scenario could come to pass over the near term, we expect that the projected 100% increase in GDP growth by next year will come to the rescue.

Just like the miners canary, the Greiner-Maltz listing database has become our market's health "first alert".

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