
MARKET COMMENTARY

Why Rates Matter Less Than You Think

The opportunity hiding behind the interest-rate debate

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Archimedes claimed that with a long enough lever and a place to stand, he could move the Earth.

For much of the last decade, real estate investors celebrated the lever. Cheap, plentiful debt let buyers pay ever-higher prices for apartment buildings and still show attractive projected returns, and rising values seemed to confirm the strategy.

High interest rates have since penalized property owners and driven prices lower. **Yet these same market conditions are discouraging new construction, thinning the pool of buyers, and improving the near-term outlook for existing properties.** While the market fixates on the cost of money, it may be overlooking the value of what that money can buy.

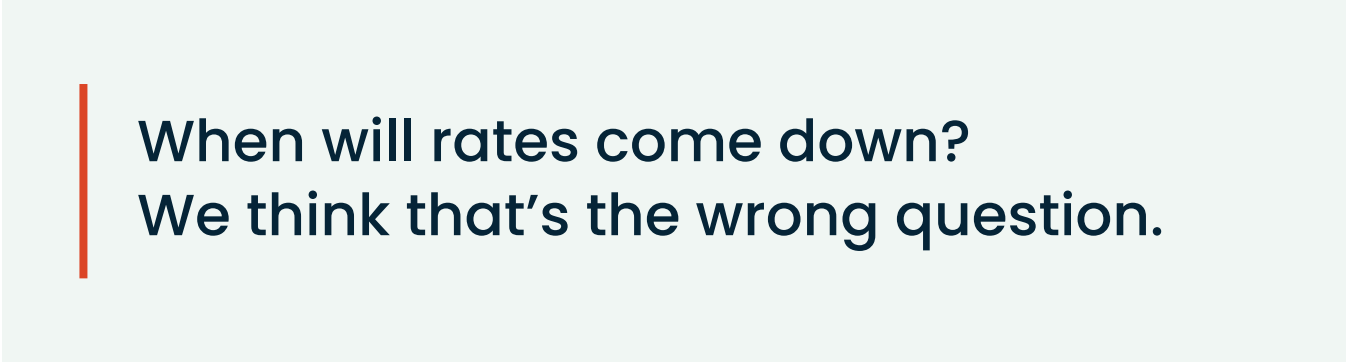


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The wrong question

Today's apartment market is a study in creative destruction: the same interest rates that have punished current owners are **creating what may be the best buying opportunities in more than a decade**. The buildings haven't changed, people still need places to live, and in many markets rents are higher than they were a few years ago. Meanwhile, with borrowing costs roughly doubled and labor and materials costs on the rise, there is limited new apartment supply.

Yet what investors are willing, or able, to pay for an existing building has fallen, sometimes dramatically. The culprit, by near-universal agreement, is the cost of debt, and **the industry has become consumed by one question: When will rates come down?**



When will rates come down?
We think that's the wrong question.

Are rates a reliable guide to property values?

Unfortunately, history doesn't provide a tidy answer

- Commercial property values fell sharply in the early 1990s even as Treasury yields declined. Overbuilding, tax changes, and a retreat in credit overwhelmed the benefit of cheaper money.
- Rates fell again during the global financial crisis while apartment values contracted. Credit disappeared, and prices that depended on abundant financing could not hold.

The opposite has happened, too.

- Between 2004 and 2006, the Federal Reserve raised short-term rates from 1% to 5.25%. The 10-year Treasury barely moved, and commercial property values surged on abundant credit and investor demand. When that credit unwound, values fell.

Rates mattered in each period, they just weren't the whole story.

- Consider 2021. Financing was exceptionally cheap, valuations were aggressive, and generous leverage plus continued rent growth produced compelling projections. Developers responded to the same conditions by launching an extraordinary volume of new projects.
- When rates rose in 2022 and 2023, an owner with long-term fixed-rate debt and durable occupancy faced a very different situation from one with a short-term floating-rate bridge loan and a business plan that depended on rising rents.

If rates were a reliable guide, the logical strategy would be to wait for them to fall. But if a market correction comes from the interaction of prices, supply, *and financing*, the right question is: has that interaction created a favorable entry point?

Three values, different timelines

An apartment building effectively has three values: what lenders will finance, what a buyer will pay, and what the property is worth based on the income it can produce over time, given the cost and feasibility of competing supply. They are connected, but they don't move together.

A Treasury yield can change in an afternoon; a property transaction takes months, and long-term value takes years to realize. This timing mismatch is central to the current opportunity.

When capital is cheap and plentiful, buyers bid prices up and developers start new projects. When capital becomes expensive and scarce, the process reverses. Buyers retreat, prices fall, and properties

can trade well below what it would cost to build them today. Yet the buildings haven't become less productive: people still need places to live, rents can keep rising over time, and inflation keeps pushing construction costs higher.

Meanwhile, the shrinking development pipeline gives existing owners something investors rarely enjoy: years of visibility into future competition. Set aside the cost of capital for a moment: fewer buyers, lower prices, little new supply, and an asset whose underlying economics may be improving. **Isn't this precisely when an investor should want to buy?**

The hidden advantage of expensive money

Picture the same apartment building bought twice. The first buyer closes in 2021 with cheap debt, a record price, and a wave of new construction breaking ground down the street. The second buys it today after borrowing costs have doubled, the price has reset, and cranes are coming down. **The first buyer got the better loan. The second may have gotten the better building: a lower basis and years of far less competition ahead.**

That isn't to say expensive debt is painless. When borrowing costs exceed a property's initial yield, negative leverage eats into cash flow, and it turns dangerous if a loan comes due or results in disappointment.

But high rates also cap what every other bidder can pay. For a buyer with patient capital and conservative financing, the cost of debt becomes a barrier that keeps competitors out.

The real opportunity is a price that pays for today's operations, tomorrow's competition, and the chance that money stays expensive for a long time.

Why national averages mislead investors

A market absorbing a large wave of new apartments may have weak rents today even as its construction pipeline collapses. Another may enjoy limited supply and durable pricing power but offer few assets at attractive prices. **Today's strongest operating market is not necessarily tomorrow's best investment.**

Examine the relationship between a property's current earnings, its purchase price, and the competition it is likely to face.

- How many apartments are under construction?
- How many recently completed communities are still leasing up?
- What can local households afford?
- Could a developer profitably build a comparable property at today's rents and costs?
- How will taxes, insurance, and regulation affect future income?
- Can we finance and hold the property through a long period of expensive capital?

These questions are more nuanced than predicting what will happen at the next Fed meeting, but careful research can actually answer them.

What would make us wrong?

We are not claiming that apartment prices have reached a universal bottom, or that a construction slowdown guarantees an imminent recovery. Persistently high Treasury yields could push cap rates higher. A recession could weaken renter demand just as supply conditions improve. Construction could restart sooner than expected in some markets. Insurance, property taxes, and regulation could absorb more of the income growth than investors expect. And a less-discussed risk: capital could return before fundamentals improve, driving prices up and eliminating attractive entry points.

We treat these as central underwriting considerations, not remote possibilities. We look for investments that can withstand disappointing outcomes, not merely benefit from favorable ones.

The objective is not to call the recovery perfectly. It is to buy at prices that produce acceptable returns under reasonable assumptions, with room for better outcomes if the cycle cooperates.

A place to stand

We can't control where the 10-year Treasury will be next year, or predict it with any confidence. Neither can anyone else. **What we can control is the price we pay for a property, how we finance it, and how well the building is run.** We can measure what it earns, what it would cost to replace, and how much competition is likely to arrive over the next several years. Those measures are imperfect, and the future will certainly bring surprises, but those measures are a sturdier basis for investing than waiting for a signal from the bond market.

For much of the last cycle, investors competed for the longest lever. Debt was cheap, leverage was plentiful, and rising prices seemed to prove the strategy right. Then rates rose, and many owners learned what a long lever does when the footing shifts.

Today the lever is shorter; that much is obvious. **Less obvious, and potentially more important, is that the place to stand may have improved.**

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