The Importance Of CAP Rates

Buying real estate at the correct price is a fundamental rule of investment. A property is only as good as the cash flows it produces so the most common method of valuing a building is based on yields, or what are known as the capitalization rates (or cap rates).

The cap rate gives the first indication of the investment worthiness of the property and shows the potential rate of return on the investment. The higher the cap rate on acquisition of a property, the better it is for the investor.

The cap rate is simply the net operating income (NOI) of the investment divided by the purchase price. The NOI is the expected cash flow available, before deducting any financing costs and is usually viewed on an annualized basis. As an example, a property with a cap rate of 8% is expected to generate a return of 8% to the investor, excluding any provision for loans. So, if the property has a current market value of $15 million and the expected annual cash flow from rent, nett of any operating expenses, is $1,2 million, then the cap rate = ($1,2 million/$15 million) = 8%.

Cap rates are also used to establish the value of a potential opportunity available for purchase. By dividing the estimated NOI of the property by the industry standard cap rate of that category of building in the specific area, to obtain an estimate of the value. If you increase the cap rate, it will give you a lower valuation and if you decrease it, you will get a higher valuation.

For example, the potential opportunity offers $350,000 per year in net operating income (NOI) applying a cap rate of 7%, the offering price will be $5 million.

NCREIF and other organizations estimate cap rates for various commercial property types in the United States. The overall weighted average of cap rates for core commercial property in the United States has varied between 5% and 10% since the mid-1980s. The higher end of the range was reached in the mid-1990s, whereas the lower end of the range was a result of the onset of the financial crisis that began in 2007. Estimates of recent cap rates on U.S. commercial property ranged near long-term averages between 5% and 8% for core real estate properties in primary real estate markets.

Cap rates ultimately reflect the income prospects of a specific property which in turn also depends on the fundamentals of the property. For example, if you want to value a retail shopping mall, you need to consider its location, the catchment area, potential new supply in the area, façade, size, and age of the mall, tenant mix and rentals, etc. Based on this analysis, an investor may well decide that a cap rate of 4% is justified or that even 6% is too low.

There are many other factors that influence the cap rate and I will deal with some of them below;

- The level of risk-free interest rates – This is the return an investor can earn from a risk-free investment, like the US 10-year treasury yield. The lower the interest is on government bonds, the more

competition there is for higher-yield assets. Also, if bond yields are low, it means that the borrowing cost will likely be low. This is very important for commercial properties, given their leveraged nature where more than half the value of the property is generally leveraged.

- Opportunity for income growth of the property – We buy properties that we can unlock growth in the NOI, by improving the rent roll through change of tenant mix, renovation and restructuring of leases.

The historical understanding of cap rates of various types of commercial real estate is very useful in appreciating the cyclical nature of cap rates and the factors influencing them. It helps us understand why there is a margin of safety in real estate investment. In general, real estate cap rates have a spread over the risk-free rate which is usually taken as the 10-year government bond. The level of spread depends on market sentiment and the expected future performance of real estate assets.

To illustrate this, consider that in the early 80s the United States was suffering from high inflation. The cap rate of approximately 8%–8.5% for commercial property was lower than the 10-year US government bond rate of 10%–12% as investors anticipated strong rental and capital gains due to continued inflation. In contrast, in 2009, the cap rates had moved up to approximately 10% even in a sub 1% interest rate environment, reflecting the high-risk premium that investors were placing on real estate as they expected real estate values to contract. In general, over the past two decades, the spread between 10-year Treasuries and cap rates in the United States has been around 260 basis points.

CBRE reported in their 2019 US Real Estate Market Outlook, that their CBRE Econometric Advisors has recently developed a new econometric model to understand the broad range of factors that drive cap rate movement. They have applied these factors for the cap rate movement for 2019. As can be seen from the table below, some factors will put upward pressure on cap rates this year, but others will cause downward pressure, effectively cancelling one another out. As a result, cap rates should remain broadly stable, through sensitivity to macroeconomic factors, but will vary by property type and market.

SEVERAL ECONOMIC FACTORS IMPACT CAP RATE MOVEMENT

Factor	Effect	Importance	Correlation	Impact on Cap Rates in 2019
10-Year Treasury Yield	Risk-free rate	High	▲ Positve (Treasury up, cap rates up)	Upward pressure
AAA/Bond Spread	Economy wide risk measure	Medium	▲ Positive (spread up, cap rates up)	Mild upward pressure
Inflation	Pushes up rent	Low	▼ Negative (inflation up, cap rates down)	Neutral
US Dollar	Affects price paid by foreign capital	Low	▲ Positive (dollar up, cap rates up)	Mild upward pressure
Quantitative Easing	Affects demand for risky assets and sentiment	Low	▼ Negative (QE up, cap rates down)	Mild upward pressure
Change in Unemployment Rate	Indicates economic strength and confidence	High	▲ Positive (unemployment down, cap rates down)	Downward pressure
Debt Growth	Increases liquidity	High	▼ Negative (debt up, cap rates down)	Downward pressure
Real Rents	Pushes up asset values	Medium	▼ Negative (rent up, cap rates down)	Downward pressure

Source: CBRE Research, November 2018

In conclusion, our Investment Committee takes all of these economic factors into consideration before approving investment into any project. We are obsessed with ensuring the capital invested is preserved and

has the potential to grow, by taking a measured view on the cap rate at the exit.

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