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Metrics for feasibility and investment in today's market

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In spite of volatility in the stock market, the gradual improvement in fundamentals in local property markets is creating some positive anxiety and two old shorthand metrics are being revived. The two metrics are increasingly being applied to new development: return on cost - net operating income (NOI) divided by cost, and return on capital - NOI divided by debt, debt plus mezzanine, or total capital stack. Lessons on leverage and liquidity have not been forgotten. Capital is selective and underwriting is rigorous. No go-go, or highly speculative investment money, is yet plentiful and neither are the investment opportunities. And this plodding but persistent pace of recovery in this economic and property cycle might well preclude the highly rewarded speculation that has occurred in previous cycles.

Feasibility for new development is, increasingly, being seriously tested by developers and investors as markets improve marginally and macro economics bump upward. On June 24th, Fantini & Gorga assembled a panel of experienced, active developers from the local property sectors to discuss the market and new development with a full house of market participants. Return on cost of 7% to 10% was the sweet spot for the range of property risks represented - multifamily to hospitality. Depressed income outweighs favorable interest rates and cost of construction and land prices. The panel was generally consistent in reaching the conclusion that we are not there yet. However, anecdotal sidebars about activity in the market were hopeful in all property sectors.

Each property type has its range for reasonableness for a return on cost. Embedded in the range of return is the cost of capital or capital stack with its rates and ratios. The analytical exercise includes hard costs, soft or indirect costs, and allowance for risk and profit. Perhaps less obviously embedded in the costs are the risks and allowances for rent-up and reaching stabilized occupancy. By focusing on shorthand metrics, the market can focus on favorable trends in the costs of construction, land and capital.

Volatility in the stock and debt market is a major distraction for institutional investors who are allocating capital to real estate on a competitive yield basis. The metric of return on capital has accordingly increased in popularity as capital sources interface with the developers and advisors in real estate. Because of volatility in the broad capital markets resulting from European debt market crisis, regulatory reform and other macro activity, the volatility in this shorthand metric has also increased somewhat. Investment decisions, often linked to cap rates - NOI divided by value or price, are increasingly using metrics of return on capital and return on costs, as well as multiyear modeling, because the basic assumptions for these metrics are less likely to be mistaken or manipulated.

The popularity of shorthand metrics for feasibility and investment in the marketplace is indeed a hopeful trend. At least one implication is that replacement costs are becoming more relevant as an investment measure. The second quarter of 2010 was in many ways a disappointment, and, accordingly, so was the first half of 2010. However, the summer still promises to be a busy one for commercial real estate markets. Enjoy!

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