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Capitalization rates to communicate risk and trends

March 10, 2011 - Appraisal & Consulting

Market makers use capitalization rates to communicate risk and related trends throughout commercial real estate markets. Like price earnings ratios, or PE's, cap rates are shorthand metrics for moving through transactional data for comparison, trend analysis and value or pricing conclusions. Calculated by dividing net operating income (NOI) by price or value, the cap rate is the dividend multiplied by 100. The NOI used in calculating cap rates is typically the stabilized or projected NOI for the next 12 months which is based on short term expectations. When commercial property values were projected to decline by up to 40% during this most recent contraction and recovery, market makers focused on likely income and rate trends. There are enough moving parts or variables to confound the quick and dirty, and accordingly the cap rate can be a primitive starting point or an incidental calculation at the end of any analysis. Nevertheless, cap rates are an important part of the market chatter.

Cap rates are a marker for risk. At one time a 10% cap rate was pretty safe for real estate risk. Then, a 9 or maybe an 8. In the multifamily sector, rates sunk to 7, 6, and sub-6. class A core credit trophy properties went to 5, sub-5. However, most market makers agree that risks are related to geographic markets and then property types within the market. The market, based on local economics and balance of supply and demand within the property sectors, attracts or deflects capital. Capital prices the risk. Marcus & Millichap and National Real Estate Investor in their 2011 forecast left cap rates out of its national overview and included commentary in individual metro market summary. For instance, Boston cap rates for multifamily at yearend 2010 ranged from 6.2% to 7%. Cap rates increased 40 basis points on average for office properties in Boston during 2010 to mid to high 8% range. This data without the sample or methodology is worth noting with, however, with limited utility for the counselor.

Property categories do have categorical operating risks and also tend to have differentiated and categorical building cycles which have induced category investing and encouraged cap rate generalizations by property types. Boston is a top tier market because of, among other things, favorable economic fundamentals, market constraints from arduous entitlement process, and an abundance of competitive capital. Except for possibly industrial property cap rates, Boston transactions will be in the lower range of cap rates for all property types in national surveys and have been throughout the recession and recovery.

With the sluggish economic recovery, the perceived risk patterns are apparent if not precisely described in market transactions. The multifamily market might be a 6 to 9; office, a 6 to 10; retail 7 to 12; hospitality, 8 to 12. Because we are a top tier market, outlying lower rates are possible. Now tell me about your property.

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