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If one is to be in real estate, commercial real estate is surely a nice place to live right now

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Several surveys by major brokerages contain statements such as, "Investors are once again proving that their confidence in commercial real estate remains steadfast... a majority of investors expect both core fundamentals and property values to continue to rise in the coming year. That positive outlook is fueling a desire to further expand real estate holdings." Another survey shows a steep positive trend since 2010. Yet another survey suggests that markets like the U.S. are generally safe havens (at least, certain cities and regions) but significant uncertainty exists.

If one is to be in real estate, commercial real estate (CRE) is surely a nice place to live right now.

A major survey recently noted that investors are "excited" about continued positive trends in commercial real estate (CRE). Many investors would note a lack of quality product characterizes many strong markets with Boston among those. However, it notes some concerns about the use of "aggressive" residual capitalization rates.

What is the difference between a capitalization rate and a residual capitalization rate? Aren't you glad you asked?

There are many capitalization rate flavors out there. Everybody has an opinion as to what the "cap rate" is, could be, or might have been.

A cap rate is used to capitalize income and represents the relationship between income and value/sales price. Thus, most commonly, Net Operating Income (NOI) is capitalized (i.e., divided) by the "cap" rate to arrive at a value. Also, a cap rate can result by dividing NOI into a sales price or value. NOI is income remaining left over after operating expenses and vacancy/collections are subtracted from gross income. Getting to NOI can in itself be an artful struggle: disagreement can arise between otherwise qualified professionals as to what should be included and excluded to get NOI.

Without further discussion about NOI, cap rates arise based on current income, trailing historical income, average income, anticipated income, pro forma income, and so on. Most discussions regarding cap rates begin with defining what income and assumptions about the income hold true.

A residual cap rate is a rate used in discounted cash flow analysis (DCF), another form of processing income to produce value. DCF analysis processes income flows forecasted over a holding period - say, 10 years - rather than "capitalizing" one year's NOI.

Many investors, appraisers, and lenders find DCF crucial in evaluating properties with irregular income patterns or shifting lease characteristics. Many believe DCF provides an extremely accurate model of the anticipated behavior of a piece of real estate. This may be true, as long as the assumptions reflect what investors think will happen. As with anything that makes assumptions about the future, rosy feelings about the future lead to unrealistic assumptions and an uncooperative economy can put DCF models on their heads.

One key assumption in DCF is the terminal rate. This rate capitalizes the final year's NOI to create a reversionary value at the investment's end and whose present value (a value that accounts for the time value of money) is added to the present value of the cash flows.

This is a key assumption. As that future value is usually a big one, even discounted from a 10 year horizon, it weighs substantially on the value as a whole. Someone feeling extremely positive about the future would forecast an aggressive ("low") terminal rate which would have the effect of increasing the value. (It's actually one of only several ways to influence the value upwards, but that's for another time.)

Most surveys have continued to show some form of cap rate compression almost across the board in property types. This is true for residual rates as well as going in rates.

Even in markets that can be classified as recovered and in expansion, aggressive residual rates represent "bets" on the future that may not come to pass. No one can predict the future with certainty; thus, prudent forecasting based on a sound understanding of the current environment and the thinking of intelligent investors must prevail over the "buy now, worry later" investor mentality.

It's not time to sound alarms. It is worth considering the effect of optimistic "short term" predictions applied to "long term" investments. Blue skies don't last forever. A real estate investment that is held for ten years is likely to experience more than a few "bumps" in the economic road.

Bill Pastuszek, MAI, ASA, MRA heads Shepherd Associates LLC, Newton, Mass.