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Understanding how investors invest in a complex real estate market

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In the current commercial environment, most real estate investment markets continue to see cap rates inch downwards in a phenomenon called "rate compression." Why is this happening?

A major, respected investor survey in their 4th quarter findings note that average overall capitalization rates decreased in the majority of their markets and that the declines are "diverse" and "spread across" property types and locations. Largest decreases were noted in medical office and regional mall property groupings. The national warehouse market also experienced compression, which is consistent with increase economic activity. Other surveys indicate similar trends.

Investors invest because that is what they do. There are times when investors don't invest and that doesn't happen very often but it did during the Great Recession. Then there was no financing and there was fear because of massive uncertainty about the future. There were other factors in play too. In any case it took some time for many investors - on the equity and debt sides - to begin to behave normally.

What is normal behavior? For investors, it is finding places to put money where there a reasonable certainty of getting back the investment at its end and there is some certainty of achieving a return commensurate with the investment's perceived risk and in line with alternative investments.

Interest rates continue to bounce along the bottom, with the central bank winking broadly that they are likely to remain so for the time being. That's certainty: so, lenders can lend, investors can borrow and then invest. Economic signals point to stability.

Looking at cap rates in the context of lower financing costs is instructive. Lower financing rates today tend to influence rates downward and lower financial benchmarks also tend to influence investor return expectations downward. That there is a fallacy in thinking that lower financing rates always result in lower cap rates and higher prices is part of what led to problems during the downturn.

Availability of financing is a key factor for investor behavior. The price of financing is important but secondary to the ease with which credit can be obtained. While this seems obvious, it's the ease with which credit that can be secured that needs underscoring. This is another factor to add to a complex model and as credit is easier to obtain within a reasonable period of time, the nature of how risk is underwritten must be considered.

As markets have improved, sources have noted a "deterioration" in underwriting standards and transactions being driven more by "price" than "value." The effect of taking the brakes off investor behavior forces more conservative equity and debt investors to become more aggressive or be consigned to the sidelines.

There's the notion that investors are indifferent to sources of return as long as the return matches the risk. But that supposes all investors have similar levels of knowledge and comfort levels with any

investment. Not true. Investors tend to be specialists and invest in what they know or can know. Especially true in real estate.
Why do real estate investors pay the prices they do and generate today's low cap rates? Is it because these rates look pretty good compared to returns available elsewhere? Is it because of pressure to buy now as future prices may be higher? Or, is it because investors must invest because that's what they do?

Real estate is a complex investment vehicle, which is not to say other assets are not. Real estate has the unique characteristic of a fixed location and a resulting lower level of liquidity. It also tends to operate cyclically, not always in sync with investor expectations. Property types tend to operate independently of each other (but not totally in a vacuum) and, while generalizations are tempting, they can lead to misleading and incorrect conclusions.

Despite continuing efforts, real estate markets are not overly transparent and their small sample sizes tend to make it hard to spot trends easily. Concluding that all real estate markets move in lock step and that investors are indifferent to what they invest in are two misconceptions that lead to misinterpreting market data.

In today's market, it's tempting to paint everything with the same brush but, it may be important in the end to finally reflect how investors invest and and their expectations from particular investments and leave try to understand the whys to the wisdom of future informed hindsight.

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