Real Estate Cap Rate Discussion

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Primer on Cap Rates

One of the primary metrics that real estate investors use when considering an investment is the cap rate. What then is a cap rate? Conceptually, the cap rate (short for capitalization rate) is the annual return on a real estate asset assuming no mortgage. It is calculated as the Net Operating Income, or NOI, divided by the Purchase Price (or market value) of a property. For example, if Bellaire Real Estate Funds buys a property with a 5% cap rate—for all cash with no loan—the annual return should be 5%. However, the actual unleveraged return needs to take some things into consideration. For instance, not just the purchase price in the denominator; the calculation must take into account such factors as closing costs, working capital, and reserves for the capital expenditure budget that are added to the purchase price to derive the total investment amount. The numerator, the NOI will be adjusted by variances of the actual income and expenses when compared to the forecasted or historical income and expenses.

The higher the cap rate, the lower the price of the property. Hence, there is an inverse relationship between cap rates and prices". In a profitable scenario, the cap rate at which one sells a property will be lower than the cap rate at which one buys the property. When cap rates are the same at the date of purchase and the date of sale, the purchase price can rise if NOI increases. If cap rates are higher when one sells a property compared to when one purchased the property, then NOI must increase even more for the sale price to be higher than the purchase price.

An important result of utilizing cap rates in investment analysis is that a small increase in NOI has a profound effect on the value of the asset. For example, if in a 100-unit building rents are increased on all units by $50 per month, (assuming the expenses are stable,) the NOI increases by $60,000 per year ($50 increase X 100 units X 12 months). If one assumes a cap rate of 5%, the property value has increased by $1.2 million. (60,000/.05).

Exit Cap Rate Assumptions

When analyzing the return on investment, one must make assumptions about when a property will be sold and for what price. Once the investor has determined what the investment time horizon is, there are several factors to be considered in forecasting the sales price. How much are rents going to grow annually? How much will expenses increase over the timeframe? Once the investor has decided on those assumptions, an NOI can be calculated for the time of sale. The next step in calculating the sales price is predicting what the market cap rate will be. Typical investment models assume 10 to 20 basis point cap rate "expansion" annually. That means that after a five-year hold, the investor assumes that cap rates will be .5 % to 1 % higher than they are on the date of purchase.

The cap rate assumption at the time of sale, or the Exit Cap Assumption, will have a profound

effect on the sales price and accordingly, on the return on the investment. For example, a property with a forecasted NOI of $1 million will sell for $20 million at a 5% Cap; it will sell for $18.2 million at a 5.5 % Cap, and it will sell for $16.7 million at a 6% Cap. Assuming the original equity investment in the property was $5 million, the delta in return on investment would be 67% between a 5 Cap and a 6 Cap on exit ($20,000,000 - $16,666,667)/$5,000,000).

Forecasting Cap Rates

Is a 10 to 20 basis point per year cap rate expansion reasonable today? Some experts say that as interest rates rise, cap rates will rise as well. Since interest rates are historically low, many people reason that interest rates, and hence cap rates will increase in the future. However, other experts ignore the actual interest rates and analyze the "spread" between interest rates and cap rates. Historically, the average spread between the 10-year Treasury and Multifamily cap rates has been about 250 basis points. Today, the spread is closer to 350 basis points. If interest rates rise, there is a buffer of at least 100 basis points against an increase in cap rates. That said, the overwhelming trend has been down for interest rates over the past 20 years, with several short-term spikes. Some experts feel that the trend is not likely to reverse.

Besides interest rates, other critical factors influence cap rates. "Investor Demand", "Renter Demand" and Inflation are primary elements. As more money flows into real estate assets, cap rates compress. This is because competition for good assets causes investors to settle for lower returns. As business activity (jobs) increases regionally, the population tends to migrate to where the jobs are, and competition for housing drives increases in rents. Investors tend to follow increased renter demand which drives cap rates down. Inflation has a multifaceted effect on real estate values. As stated earlier, rental increases drive investor demand, and inflation causes rental increases. Moreover, real estate has historically been a hedge against inflation.. Inflation, therefore, results in even more investor demand for real estate, which drives cap rates lower.

Conclusion

We continue to use 50 to 100 basis point cap rate expansion as an assumption for five-year investment analysis. This assumption is conservative and therefore appropriate in the markets in which we invest. Besides the general condition of a surplus of investment funds seeking assets, there is a transfer of geographic focus of many real estate investors from the two coasts to more business-friendly and landlord-friendly states with lower income tax rates. Accordingly, we are seeing elevated investor demand in the Texas markets in which we currently invest. In addition to the investor demand in Texas, Dallas Fort Worth, Austin, Houston and San Antonio are all experiencing significant increases in population. With increases in population, comes higher rents and increased real estate values.

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