



Enterprise Capital Innovations, Inc.

## **Commentary November 13, 2005: 5.50% Cap Rates – What a deal!**

Somehow (not surprisingly) my email address found its way into the database of a few major commercial real estate brokerage firms. Every few weeks, I receive the “opportunity of a lifetime” emailed directly to me complete with an address, nice photos, and investment highlights. Fortunately, there’s only one thing I have to look at. That’s the cap rate.

For those of you who are new to commercial real estate, the capitalization rate (or cap rate as it’s commonly referred to) is the rate of return measure used to compare various types of real estate investments. The cap rate is simply the net operating income divided by the purchase price. It is analogous (in some respects) to the dividend yield on a stock or the current yield on a bond. Stock and bond valuation requires more complex models and assumptions which I won’t address here, but many of the same principles apply. An asset is an asset, and all assets derive their value from their anticipated future cash flows. (Finance 101)

The cap rate assumes you are not borrowing money to make the purchase, although most people do obtain a loan to finance at least part of their real estate acquisition. That’s one of the nice things about real estate is the availability of credit to enhance the returns on good, solid real estate investments. If you purchase a \$5,000,000 strip mall that pays you \$275,000 per year after all expenses, then you have purchased a property with a 5.50% cap.

Ignoring the fact that your total cost of credit in this market will far exceed your measly 5.50% return, what happens when interest rates go up even further – even assuming you paid cash for the entire cost of the investment? The 5-year treasury yield is now 4.48% and rising. CD’s are paying in the 4.00% range. They’re risk-free investments, and you don’t have to listen to whiny tenants, fix the roof when it leaks, or deal with vacancies.

Let’s say CD’s go up to 5.50% by the end of next year or the stock market actually starts doing something positive for a change. Who is going to want to buy your building that returns 5.50% when they could just park their money in U.S. Treasuries or CD’s and not have to be a landlord? There is always a way out – one could just lower the price until the property offers a much higher cap (say 8.75% or 9.00%). That of course translates into a major loss which is exactly what a lot of investors have to look forward to over the next few years.

Many of these investors make the following arguments:

I sold my existing property and had to do a 1031 exchange to avoid paying taxes.  
I paid cash and don’t plan on selling the property when interest rates go up. Besides, I expect rents to go up.

Well, taxes will make people do things contrary to what makes the most economic sense. A 1031 exchange, however, is only as good as the replacement property involved. If you sell your existing property at a ridiculously high price and buy a replacement property at an equally ridiculous price, then you really haven’t accomplished anything but make your real estate agent and lender happy. In addition, you likely carried forward a healthy deferred gain that may rear its ugly head in a few years if you have to sell and can’t find another replacement property.

Many smart investors sold in this market and bit the bullet – taking advantage of one of the lowest historical capital gains rates in history.

As for the second argument, that's anyone's guess. Bondholders often make the same argument by saying they are holding their bonds until maturity and don't care about interest rates going up or what similar issues are now yielding in the market. What they fail to realize is the opportunity costs of earning an inferior return when similar assets in the marketplace are paying a lot more. In addition, you never want to be in a situation where if you have to sell, you'll take a bath.

I am seeing some higher caps in the marketplace – some even in the 8.00% range. I still personally believe that return is too low given the level of risk involved and the overall direction of interest rates. You also have to be careful and do your homework. How did they calculate the cap rate? Is it based on current rents or some unrealistic assumption of what they might be in the future? Have all applicable expenses been accounted for? Are they paying a management company? Are their vacancy assumptions realistic given current market conditions? When do the existing leases expire or come up for renewal? Are the tenants reliable and creditworthy?

“So if you're a real estate guy, why are you so negative on the market today?” you ask. I just find it to be currently overvalued in many respects. I'm not freaking out like a lot of people. I just think values need to come down a little or we need to see a definitive observable trend of lease rates going up. In the long term, I do see real estate as the superior asset class to protect one from inflation and a future filled with uncertainty.

**Kenneth W. Hamby, Jr., CFA**

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