

# Capitalization Rates: How Low Will They Go?

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Over the past 12 months, we have watched as Capitalization (CAP) Rates (also known as the Risk Rate) have fallen to an all-time low. These rates are used by Real Estate Professionals to convert the expected net operating income of a property over a certain period of time into a present value number. For many years, a 10% CAP Rate was as common as a 75% loan-to-value (LTV) and a 1.25 debt service coverage ratio (DSCR). Now, we are seeing CAP Rates dropping as low as 5% on certain property types (in California). At the same time, interest rates have reached a 40-year low. This has definitely created a “Sellers Market”. They can charge more for their properties, and Buyers are willing to pay higher asking prices because they can borrow more money “cheaper” than ever before. But what has *really* changed to make that property worth more than it was just 12 months ago? The answer is NOTHING! In fact, a lot of properties are performing even worse now than they were one year ago. Occupancies continue to fall, rental rates are stable at best, and new products continue to enter every market segment. It’s a case of “money chasing deals” and, once again, greed and stupidity are back together.

CAP Rate refers to the interest rate that is divided into an established net operating income as a means of establishing a current market value, i.e., a net operating income of \$500,000 / 10.0% CAP rate = \$5,000,000 value. This value, together with the replacement cost

value and the income approach value, is the basis of all appraisals today.

However, not all income streams are created equal; some have more risk than others. The right Cap Rate will help to establish what a buyer should pay for a property’s income stream. The more certain an income stream, the lower the Cap Rate; the less certain an income stream, the higher the Cap Rate. So, how is the CAP Rate established? Below is the one method used to establish an economic CAP rate (Exhibit A):

ECONOMIC CAP RATE EXHIBIT A		
Loan-to-Value-Ratio.....	75.00%.....	0.7500
Interest Rate .....	8.00%	
Amortization.....	30	
Payment Constant.....	8.81%.....	0.0881
<b>1. LTV * Constant = .....</b>		<b>0.0660</b>
Actual Borrower Equity .....	25.00%.....	0.2500
Anticipated Equity Return.....	10.00%.....	0.1000
<b>2. Equity * Equity Cash Flow = .....</b>		<b>0.0250</b>
<b>Estimated Cap Rate: (Sum 1 + 2) = .....</b>		<b>9.10%</b>

ECONOMIC CAP RATE EXHIBIT B		
Loan-to-Value-Ratio.....	75.00%.....	0.7500
Interest Rate .....	6.00%	
Amortization.....	30	
Payment Constant.....	7.19%.....	0.0719
<b>1. LTV * Constant = .....</b>		<b>0.0540</b>
Actual Borrower Equity .....	25.00%.....	0.2500
Anticipated Equity Return.....	10.00%.....	0.1000
<b>2. Equity * Equity Cash Flow = .....</b>		<b>0.0250</b>
<b>Estimated Cap Rate: (Sum 1 + 2) = .....</b>		<b>7.90%</b>

As you can see, a basic “vanilla” deal yields approximately a 9% CAP Rate.

Now, just drop the interest

rate to today’s 6% and look at the effect: The CAP Rate falls to just under 8% (Exhibit B). But where is the logic behind dropping CAP Rates down to the same level as interest rates? What is driving these absurd 4%-6% CAP Rates? Even if the interest rate fell to the current Federal Reserve Discount Rate of 1%, the economic CAP Rate would still only be 5.4%. Didn’t we learn anything during the 80s and 90s?

Remember that old saying: “What goes around, comes around.” And don’t forget that “Murphy’s Law” still exists.

A very good way to determine a Cap Rate for a specific property in a specific market is to analyze recent sales of similar properties in that market. By obtaining the purchase price and cash flow from these sales, one can extract a range of Cap Rates which reflect the buyers risk/yield profile. By dividing the net operating income by the sales price, i.e. \$500,000 NOI / \$5,000,000 sales/purchase price = 10% CAP Rate. This method of capitalization is most appropriate when there is an abundance of market information. Typically, when rental rates and occupancies rise, CAP Rates go down and, subsequently, sales prices go up. Investors and lenders both have indicated that CAP Rates on projects

would be lower (higher sales prices) if large increases in rental rates were expected. So why are investors still paying too much for properties that are not only under-performing in both the rate and occupancy categories, but that are in overbuilt markets?

As most of us are aware, interest rates are comprised of specific indices (Treasury Rates, LIBOR, Prime) plus a seemingly arbitrary percentage called a “spread”. Whether the rate is fixed or floating, this spread has become one of the most negotiated parts of every real estate transaction. While interest rates and CAP Rates are obviously related, historically that has not always been the case. Remember back in 1984 when interest rates went as high as 18-20%, and in 1998 when they went as low as 4-5%? CAP Rates did not follow suit. Once again, interest rates are at an all-time low. Spreads are thinner than ever, and now CAP rates are tumbling down to unprecedented lows. In fact, in some cases CAP rates are LOWER than current interest rates. After 1998, lenders quickly learned to establish floors on interest rates when rates start heading south. How long will it take someone to establish floors on CAP Rates?

Take a look at this example: An apartment complex is up for sale. The Seller states that the actual NOI is \$240,000, and using a 6% CAP rate, he sets the sales price at \$4,000,000. The Buyer can get a 75% LTV (\$3,000,000), 10-year loan with a 30-year amortization at a current interest rate of 6.00%. His annual payment will be approximately \$216,000 generating an annual cash flow profit of \$24,000 and yielding a 10% cash-on-cash return referred to in the economic models above. Everything seems perfect.

STOP!

Let's take another look at it.

- Under the economic CAP Rate scenario, the CAP Rate should be 8.0%, not 6.0% (Exhibit B). That cuts the value to \$3,000,000, and he's paying \$4,000,000!
- If the CAP Rate is 8.0%, then shouldn't the interest rate be 8.0%? In *that* case, his annual payment would be \$264,000! THAT deal doesn't underwrite!
- Let's assume that he buys it for \$4,000,000, and a Lender actually accepts that value and gives him a 6.0% loan. He holds the property for five years, and then decides to sell. His NOI has gone up 3% per year (generous, I know) to \$278,000. CAP Rates have adjusted back up to 9%. The property is now worth only \$3,100,000 at best, and he has to sell it at a loss. OR, if he holds the property for 10 years under the same scenario, it will only be worth \$3,600,000!

CAP Rates are so subjective. As we are all painfully aware, the final say on any appraised value is the institution for which it is produced. Regardless of what our Borrowers believe their properties are worth and what our years of experience lead us to believe the properties are worth, we all succumb to the values and beliefs of the Appraiser. *Not Any More.* Now more than ever, we find Lenders questioning Appraisers' conclusions, especially the CAP Rate that they have determined was proper and justified for a particular property type, in a specific market, at a moment in time. So, notwithstanding

the fact that MAI prepared appraisals are bought and paid for in every transaction, Lenders adjust the value based upon an arbitrary set of facts that they deem appropriate, based upon the perception of the market, borrower strength, and, most importantly, their risk in the deal. Can we really blame them?

These days, most of us are once again allowing our shortsightedness to drive the train. Savvy investors are just sitting by the wayside, waiting for the inevitable fall-out of over-leveraged properties to return to the market via borrower bankruptcy and/or lender fire sales.

This time it will not take an act of Congress (the RTC) or distressed foreign markets to seriously affect the Commercial Real Estate Industry. It will be bad decisions made by over-confident investors that do not (or cannot) remember what happened the last time we forgot to *learn from our own mistakes.*

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