Mohr Partners, Inc.

CAP Rate Compression - What Does It Mean?

Capitalization Rates, or Cap Rates, are a key performance measure for any commercial real estate investor. A property's Cap Rate represents the rate of return that the investor would receive on an all-cash investment in a property if it were occupied by a reliable tenant. Very simple on the surface, they are determined by dividing the net operating income (NOI) by the total value of the property. Generally speaking, the higher the Cap Rate, the better the investment for a given level of risk. "Sometimes the values of properties are bid up by the market even when NOI's remain unchanged, effectively lowering the Cap Rates. This is what we call Cap Rate compression and it is happening in U.S. markets right now," said Dr. Philip Seagraves.

Most of the time, Cap Rate compression indicates that prices in a market are rising and that investors perceive investment real estate as a low-risk, high reward asset class relative to other options. While it may be tempting to assume lower Cap Rates are associated with lower risk, the opposite may in fact be true when Cap Rates are pushed down because of increased property values. "A compressed Cap Rate environment may be great for existing investors looking to unload property, but not so great for those looking to break into the market," Dr. Seagraves added.

Part of the reason for the current Cap Rate compression is the sheer mass of cash in the market right now. REITs, hedge funds, and other institutions such as life insurance companies are paying record high prices for properties, producing a highly competitive landscape that brokers and other sellers are taking advantage of. Even international entities such as sovereign wealth funds and private investors from Asia are showing a huge demand for U.S. real estate. In fact, offshore investment in U.S. real estate is at an all-time high, as those investors are looking to protect their capital rather than produce high returns, thus driving down overall rates even further as investors compete to purchase safe assets such as real estate.

As interest rates rise, additional pressure is placed on real estate investors who typically leverage their investments with debt. With property yields at or even lower than market interest rates, investors must pay 100% cash for real estate. Since the majority of real estate investors rely heavily on that leverage to make their purchases, Cap Rate compression locks many investors out of the market entirely, at least until Cap Rates increase or interest rates decrease. "When yields are so low that you cannot borrow to purchase real estate, the market tends to peak. Cash is king, but cash can also chase an asset class like real estate off a cliff," said Dr. Seagraves.

With the current low yields on many classes of commercial real estate, investors snapping up properties now are looking for the safe security of credit tenants and long term leases. Many current owners looking to cash in on high prices by selling at a time of unusually low Cap Rates will be willing to renegotiate lease terms with existing tenants to extend term in exchange for lower rates. "This may be a great time for tenants to recast their leases and lock in lower rates in exchange for going out for a longer term. It's a win-win for landlords and tenants alike," added Dr. Seagraves.

Services Utilized

Transaction Advisors