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Cap-rates and watching paint dry: Appraisals are like a work of art with some science mixed in

May 11, 2015 - Upstate New York

Some people have the impression that the appraisal process is like watching paint dry. That may be true because an appraisal is more like a work of art with some science mixed in. But instead of being a Da Vinci or Michelangelo, appraisers are probably more like the abstract artist, Picasso. Other than the final value, the most common question that appraisers get is something like this; "What cap-rates are you going to use?" Beside the value, non appraisers really get curious about cap-rates.

The full and proper label for the term "cap-rate" is "overall capitalization rate." It is simply the ratio of Net Operating Income divided by Sales Price or NOI/SP. Given the lowest interest rates in my life time, overall capitalization rates are at or near the historic bottom at least in modern times. As an example, in Upstate New York and New England outside of the major metropolitan areas of New York City and Boston overall capitalization rates have a significant tendency around 8.25% for small office buildings. Class A office buildings have a significant tendency around 7.5% for an overall capitalization rate. Class B office buildings have a significant tendency around 9% for an overall capitalization rate. For the larger metropolitan areas like New York City and Boston the overall capitalization rate range for offices have a significant tendency around 6%. For regional retail in the region outside of the major metropolitan areas of New York City and Boston overall capitalization rates have a significant tendency around 7.75%. Community retail overall capitalization rates have a significant tendency around 8.25%. Neighborhood retail have an overall capitalization rate of a significant tendency around 8%. In contrast, the larger markets around New York City and Boston have overall capitalization rates of a significant tendency around 5.5-6%.

For heavy industrial in the region outside of the major metropolitan areas of New York City and Boston overall capitalization rates with a significant tendency around 10% are applicable. Light industrial overall capitalization rates have a significant tendency around 8.75%. Research & development types have an overall capitalization rate of significant tendency around 8.5%. In contrast, the larger markets around New York City and Boston have overall capitalization rates of significant tendency around 6-6.5%. For existing apartments in the region outside of the major metropolitan areas of New York City and Boston for apartments have overall capitalization rates have a significant tendency around 7.25%. New apartments overall capitalization rates have a significant tendency around 6.25%. In contrast, the larger markets around New York City and Boston have overall capitalization rates for existing apartments of significant tendency around 5.5-6%% and 5-5.5% for new apartments.

There are some areas in Upstate which are below the norm in regards to overall capitalization rates such as parts of the Mid Hudson, Ithaca, Pittsford, Amherst, Albany Region, etc. where the economy is relatively strong. There are areas above the norm in regards to overall capitalization rates such as the North Country, Binghamton, Elmira, Jamestown, Wellsville, Hornell, etc. where the local economies are relatively weak. The bulk of the survey is based primarily upon properties in Upstate New York and most of the western/central New England region. As was outlined earlier, the metropolitan areas of New York City and Boston are a substantially lower overall capitalization rate atmosphere due primarily to superior demand factors and tighter supply. Lower end rates generally represent newer/modernized, higher quality suburban properties. Upper end rates generally represent older lower quality urban properties. The outlined rates generally do not represent highly distressed properties. These rates assume that adequate management and reserve expenses are considered. This is an important consideration and if not handled properly can really skew the income approach value estimate.

The 1st quarter of 2015 did show some continuing downward pressure on real estate investment rates compared to the 4th quarter of 2014. Mortgage interest rates trended downward throughout the third and fourth quarters of 2014. This was in part due to signals from the Federal Reserve that the low interest rate policy would continue to be applied due to low inflation and slow income growth. Also, many of the transactions in the 1st quarter were based upon the 4th quarter interest rates of 2014. Interest rates trended downward in the 1st quarter of 2015 because of monetary policies of the Federal Reserve.

As far as watching paint dry, I sure hope it's not lead based paint. That's a whole different topic to be discussed again at a later date.

John Rynne, MAI, SRA is the president and owner of Rynne, Murphy & Associates, Inc., Rochester, N.Y.