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Wild and crazy cap rates? - by John Rynne

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2020 was a wild and crazy time. We had and still have the COVID-19 issue which reportedly originated in Wuhan, China and quickly spread throughout the world. 2020 produced a very contentious election highlighted by the presidential and senate races amid serious allegations of irregularities which produced unrest. The effect on overall capitalization rates remains one of the biggest concerns for valuation experts and investors. COVID-19 certainly had a greater negative effect on real estate than the recent election—especially on regional malls, hotels, gyms, and restaurants. To a lesser extent office and direct outside access retail have been negatively affected. Industrial, warehouse, flex space, and apartments are property types which have been least affected other than single-family houses. Higher quality apartments have not been negatively affected as much as lower quality and average quality units. Higher quality units typically have tenant income levels and employment which can withstand short-term interruption of income since these tenants can work remotely. Lower income tenants are more apt to not have substantial back up resources and employment in a job which is not amenable to working remotely.

In New York State, there are moratoriums against evictions and other relief measures to protect tenants in the event they are not paying rent. As a landlord, I had a situation where there was a threat of a tenant movement to avoid paying rent. About 20 years ago, I sold a small apartment complex which consisted of low-middle income tenants. One of the tenants passed the word around that the residents should withhold rent because I wouldn't pursue them after the property was sold. Fortunately, not many listened to her. Five years later, the organizer of this rent insurgency had the gall to use me as reference for a new job. I quickly rejected her request to use me as a reference. The landlord, especially the financially small one, will be hard pressed to pay the mortgage, real estate taxes, repairs/maintenance, etc; if tenants stopped paying rents. This creates a dilemma for investors and lenders by increasing the risk of the asset, which naturally increases overall capitalization rates.

Of course, the office market has been negatively affected. Part of the reduction in demand for office space will be offset by larger footprints needed to accommodate less congestion. However, because of the still historic low interest rates, the effect on cap rates is lessened. Instead, credit loss becomes a bigger issue which can severely affect the Net Operating Income (NOI). So the diminishment to value is two pronged:

A. Higher cap rates; and

B. Higher vacancy and credit loss.

However, the tolerance for real estate is enhanced by the low returns for alternative so-called safe investments, such as treasury bills, CDs, etc. Through the first three quarters of 2020; 10-year treasuries dropped precipitously by over 125 basis points. As an example, on January 3rd, 2020 the 10-year treasury rate was at 1.81%. On August 10th, 2020 the 10-year treasury was at 0.55%, but on December 30th, 2020 it was 0.93% or less than 100 basis points.

These low interest rates give the government the incentive to deficit spend and increase the national debt. The intermediate and long-term problem is high inflation which will aid in the increasing of real estate values which traditionally has been a hedge against inflation. This assumes that there isn't an oversupply of space and/or a lack of demand. During the 4th quarter of 2020 and the 1st quarter of 2021, treasuries have been increasing which has neutralized further decreases in cap rates

In summary, cap rate movement is very sticky. They move very slowly in reaction to indicators like the 10-year treasury rates. The more damaging part is the reduction of income in the form of vacancy and credit loss.

Here are some recent overall rates that have applied to properties in Upstate New York:

A 100,000+ s/f high tech well capitalized manufacturer property on a long-term lease had an overall capitalization rate of 6%.
A 200,000+ s/f commercial part special purpose property had a cap rate of 9%.
A sit-down restaurant with a limited regional presence and below market 10-year lease with a good location had an overall cap rate of 5.77%.
A multi-story 100,000 s/f high tech manufacturing facility had a cap rate of 9.10%.
A historic high quality Upstate city small apartment complex had a cap rate of 5.8%.
A relatively new large automobile facility had a cap rate of 8.25%.
A 25-year-old suburban office building had a cap rate of 8%.

Finally, the overall capitalization rates have not had a lot of upward movement because of the continuing low interest rates and government aid such as the Payroll Protection Program (PPP) with the exception of malls, hotels and gyms. In conclusion, cap rates are not so wild and crazy after all.

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