

FOCUS ON U.S. MARKET PRICING

Is U.S. Real Estate Priced Right Today?

BY RAYMOND G. TORTO, PH.D., CRE

AT TODAY'S RECORD PRICES, and with 20 percent total returns over the last year, many investors have found themselves asking: "Are real estate prices too high?"

Recent research shows capitalization rates in the low 6 percent range for office, industrial and retail properties, and less than 5 percent—yes sub-5s—for multihousing. Though interest rates have risen about 75 basis points since the first of the year, cap rates have barely moved. Higher borrowing rates have taken many debt-based investors out of the bidding, but evidence from the field shows that there are still large numbers of bidders on each offering, keeping prices high and cap rates low.

Analyzing pricing and cap rates means looking at their components. Cap rates form around the risk-free rate, the risk premium, capital expenditures and the expected appreciation in the net operating income and value of assets. The equation is:

$$\begin{aligned} \text{Cap rate} = & \quad + \text{Risk-free rate} \\ & + \text{Risk premium} \\ & + \text{Capital expenditures} \\ & - \text{Expected appreciation} \end{aligned}$$

The first three terms in the equation are additive and move positively with the cap rate. Higher interest rates, for instance, raise the cap rate—*ceteris paribus*. However, falling risk premiums or rising expectations for appreciation can offset higher interest rates and, if this happens, cap rates may not move in the face of increasing interest rates. This is clearly something that has happened in the past six months.

Analyzing cap rates by their components can help to set straight a terrible myth. Many analysts take the cap rate less the risk-free rate and erroneously call that the risk premium. But the difference really comprises several components:

$$\begin{aligned} \text{Cap rate} - \text{Risk-free rate} = & + \text{Risk premium} \\ & + \text{Capital expenditures} \\ & - \text{Expected appreciation} \end{aligned}$$

Since 1988, this difference between the cap rate and the risk-free rate, using the 10-year U.S. treasury note as the benchmark, has ranged from a negative 275 basis points to a high of 500 basis points, depending on the property



About the Columnist

Raymond G. Torto, CRE, is a principal and chief strategist for Torto Wheaton Research whose career spans across the academic, public and private sectors. He helped to build the Economics Department at the University of Massachusetts, Boston, and led the McCormack Institute for Public Affairs, acted as a policy advisor and led the modernization of the property tax assessing function in the city of Boston, and provides research and advisory services to real estate investment managers, federal regulators, rating agencies, and banks and pension funds around the world. He also is the author of four books and numerous articles about financial markets and tax policy.

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type. The gap now is essentially 25 basis points for multifamily and about 125 to 150 basis points for office, industrial and retail property types.

But let's return to our question. Is real estate priced correctly today? Today's 10-year U.S. treasury note is about 500 basis points and most folks would agree that the risk premium and cap expenditures together range from about 200 basis points for multifamily to 300 or 350 basis points for office, industrial and retail. Analysts at Torto Wheaton Research believe that the 100 to 150 basis-point difference is because the market realizes capital expenditures for multifamily is much less than for other property types.

I know I'm not being exactly precise here but, for discussion sake, let's assume that the risk premium *plus* capital expenditures is 300 basis points. With the risk-free rate at 510 basis points, this would sum to 810 basis points. If expected appreciation were zero, the cap rate should be 8.1 percent today. If we thought that the U.S. Federal Reserve System was going to raise the 10-year U.S. treasury note to 5.5 percent in the near future, then with an expected appreciation of zero, cap rates would be 8.5 percent.

Torto Wheaton Research's fall 2006 forecasts for real estate fundamentals predict the market will improve nicely, even with a housing and consumer slowdown built into the forecasts. The markets in general are showing strong recovery in occupancy and some good rent traction. Gross income, sometimes called economic rent, is rising annually in the 3 percent to 5 percent range on average—and

high singles or even double digits in some markets. Net operating income growth is the old-fashioned way of achieving appreciation.

Because expenses need to be subtracted from gross income, we could estimate that expected appreciation is 200 basis points. Doing the arithmetic, this equals a 6.5 percent cap rate. Operating on these assumptions, it strikes me that real estate is priced correctly; however, you should work out your own assumptions. This type of cap rate analysis can help you identify where you think the risk lies. If you predict, for instance, that the risk-free rate is going to 10, then you'll have a very different conclusion. However, I would argue that at that level, all investments today are priced incorrectly.

One last point: while research indicates that real estate is priced correctly today, economic and real estate forecasts show that pricing is very inefficient across markets. When we line up cap rates with estimates of market gross income growth, we do not see the relationship that ought to be there: a negative correlation that shows low cap rates in markets expected to do better in the future, and high cap rates in markets expected to do less well in the future. In other words, pricing is not efficient based on the outlook for markets and property types—at least based on the way some researchers see the outlook.

Of course, market inefficiency can translate into opportunities for those with the right insights—finding mispriced real estate assets can be fruitful investments for those who see the true value. ■