Market Insights

# How Investors Benefit from Lower Capitalization Rates

Commercial real estate is commonly regarded as the third largest asset class,[1] which includes stocks and bonds — but how do investors calculate the potential return or assess risk? Understanding capitalization rates is key to evaluating commercial real estate investment options as it can demonstrate how a property or portfolio of properties can perform in the long term.

## How Commercial Real Estate Is Valued

Unlike residential real estate where it can be relatively easy to analyze the value of a property and determine if prices are reasonable, commercial real estate involves many more factors that can influence its value — making it difficult to compare commercial real estate properties to one another. Location, property type, property characteristics and market conditions can affect the potential return of a commercial property, so it is important for investors to understand how to assess the true value of a property.

The capitalization rate, or cap rate, is one of the most frequently used measures of the potential yield, or return on investment, for commercial real estate properties. Generally, cap rates are indicative of property pricing and potential risk and are often compared to a bond's annual interest rate. Cap rates are the ratio of a property's annual net operating income (NOI) — or all rental income minus operating expenses such as taxes, insurance and utilities to its current value or price. If a property is expected to generate $2 million of NOI and its purchase price is $30 million, the property has a 6.7% cap rate — or the property is likely to pay for itself at a rate of 6.7% per year.

**How Cap Rates are Calculated** = $\dfrac{\text{NET OPERATING INCOME}}{\text{PROPERTY PRICE}}$

## Understanding the Impacts of Risk on Commercial Real Estate Pricing

Cap rates are highly correlated to risk — such as whether the property is in a desirable location, the ability to secure dependable tenants and command higher rents, or the changing supply and demand of market conditions — so the riskier the investment, the higher the cap rate. Usually, when a property has a higher risk profile, the price of the property is lower since there is less demand in the marketplace for the property. Due to the inverse relationship between cap rates and property prices, it's often difficult to define an optimal cap rate. For many real estate investors, a more modest cap rate of 4-5% is targeted since there is less risk associated, and the property can command a higher sales price.

**CAP RATES & PROPERTY PRICES**
**An Inverse Relationship**

When cap rates are lower, prices tend to be higher and when cap rates are higher, prices tend to be lower.

For example, a modern high-quality industrial warehouse located near densely populated areas would be expected to have a lower cap rate and higher price per square foot given its lower risk profile than an older warehouse in a more remote location without access to significant population density.

## Historically, Commercial Real Estate Has Provided a Higher Return Over U.S. Treasury Bond[2,3]

Since the Great Recession of 2008, commercial real estate cap rates drifted gradually downward and have hovered near cyclical low levels for the past couple of years, even throughout the current Coronavirus pandemic.[2] Strong tenant demand, fueled by the longest streak of economic growth on record over the last cycle, and generally restrained levels of new property supply, drove rent and, therefore, NOI growth. At the same time, however, strong liquidity in a low interest rate environment sustained strong property price growth. The outpacing of property price growth over NOI growth over the course of the last cycle has led to lower cap rates.

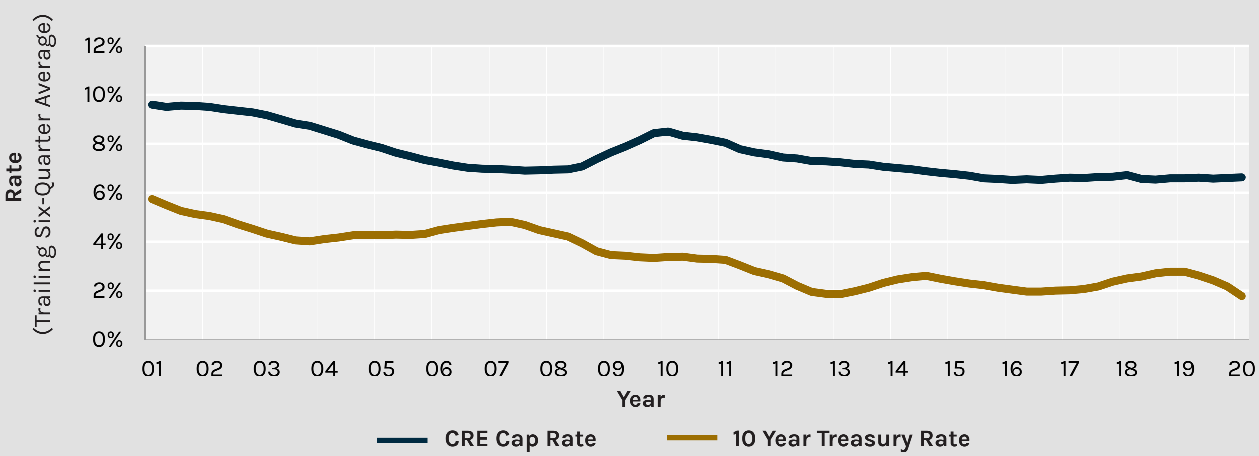
Real estate investors commonly look at the spread between cap rates and the 10-Year Treasury rate when evaluating an investment between asset classes. This spread represents the additional return an investment in commercial real estate may provide over an investment in a reliable bond. Although cap rates have slowly declined since the Great Recession, they still maintained a wide premium of more than 400 basis points above the 10-Year Treasury rate.[2] Spreads between cap rates and the 10-Year Treasury rate have generally hovered between 400-500 basis points throughout the 10 years ended June 30, 2020. At the previous cycle's (2000-2008) peak, spreads narrowed significantly to about 200 basis points, driven by strong expectations for rent (and therefore NOI) growth even as interest rates were increasing. By contrast, today's low cap rate environment means spreads are holding at over 400 basis points despite cap rates falling below the previous cycle's low.

**400**

Basis point premium between cap rates and 10-Year Treasury rate during the last decade — with commercial real estate providing a 4% higher return[2]

### Commercial Real Estate Cap Rates Compared To 10-Year Treasury RATE[2,3]

**Commercial real estate cap rates have maintained a premium over the 10-Year Treasury rate**

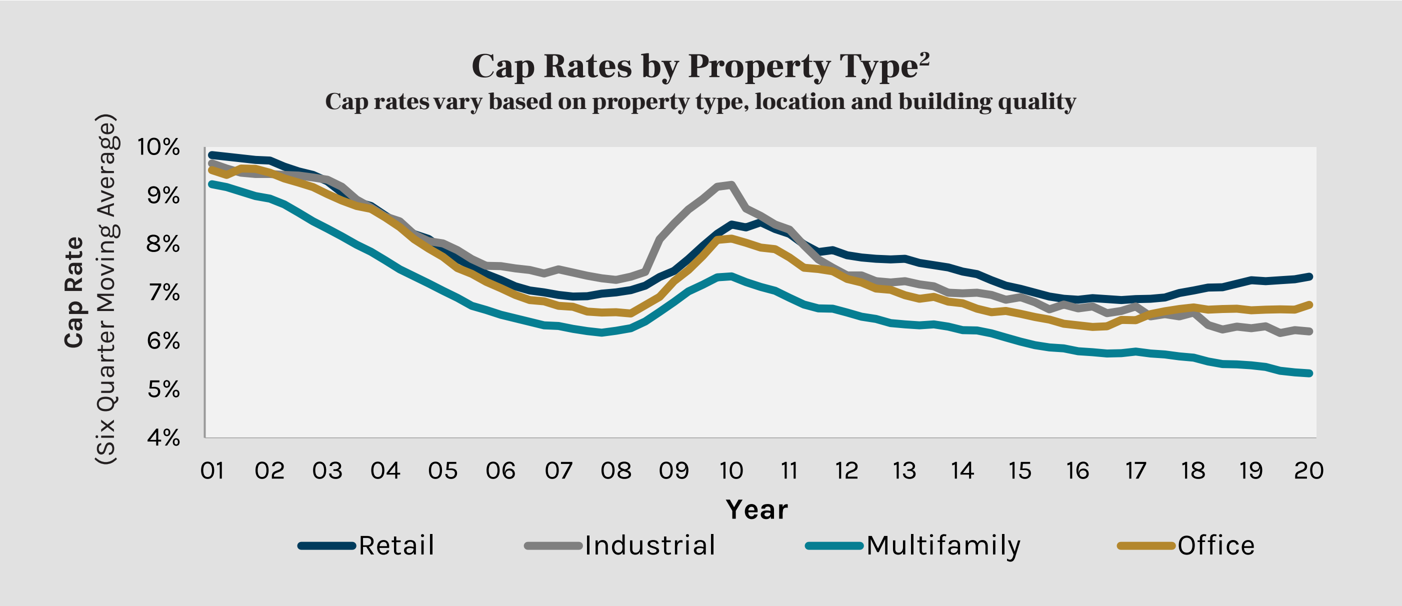



## Cap Rates By Property Type

Cap rates vary based on property type, location and building quality, representing different levels of risk. Cap rates are lowest in the multifamily sector, underscoring the strong property price growth and sustained investor interest this sector has achieved this cycle. Multifamily market fundamentals have been strengthened as the large millennial generation entered their prime renting years and are continuing to rent longer.

Industrial cap rates have declined the fastest of the four major property types since 2010, as significant demand for industrial space led by e-commerce firms has driven strong rent and price growth. Meanwhile, the headwinds that brick-and-mortar retail faces from e-commerce competition has caused overall retail cap rates to move modestly higher in the last few years as the risk of owning these properties has increased.

However, retail cap rates for well-located, necessity-based retail centers that are more insulated from e-commerce and have continued to perform well during the Coronavirus pandemic are the lowest in the retail sector. Office cap rates have been stable in recent years, as healthy fundamentals have combined with steady investor demand.




## Investing in Commercial Real Estate

With lower interest rates and lower growth on the horizon, traditional fixed income/equity portfolios are expected to see significantly lower returns. We believe an allocation to commercial real estate as an alternative to fixed income is attractive due to the wide spread over the 10-Year Treasury rate. With more than 70% of its total return over the last 20 years coming from income,[4] commercial real estate as an asset class may be attractive to investors who want a balance of growth and income.[3]

**BLACK CREEK GROUP**

*a leading real estate investment management firm, was acquired by a subsidiary of Ares Management Corporation on July 1, 2021. Ares Management Corporation (NYSE: ARES) is a leading global alternative investment manager providing clients complementary primary and secondary investment solutions across the credit, private equity, real estate and infrastructure asset classes. As of September 30, 2021, Ares Management's global platform had approximately $282 billion of assets under management with approximately 2,000 employees operating across North America, Europe, Asia Pacific and the Middle East.*

**For more information, please visit www.BlackCreekCapitalMarkets.com.**

[1] Sources: Federal Reserve, Prequin and CoStar Advisory Services. As of December 31, 2019. Includes multifamily, office, industrial, flex, retail and hotel properties. There are many material differences among these asset classes, including differences in fees and expenses, liquidity, safety and tax features.

[2] Sources: CoStar Advisory Services, as of June 30, 2020.

[3] Note that Cap Rates and the 10-Year Treasury data are based on a six-quarter moving average. The commercial real estate cap rate is a blended rate encompassing the office, retail, multifamily and industrial property types. A real estate investment bears, among other things, more capital and liquidity risk than a U.S. Treasury bond that is backed by the U.S. government. However, commercial real estate may have a higher return potential even in an inflationary period as rents can be raised, while a U.S. Treasury bond with a fixed return that is lower than current interest rates may decline in value.

[4] Sources: Bloomberg, NCREIF Open-End Diversified Core Index (ODCE). 20 years ended June 30, 2020. Income from an investment in commercial real estate is not guaranteed. Commercial real estate is represented by the NCREIF ODCE Index, an equal-weighted, time-weighted index representing a blended portfolio of institutional-quality real estate reported net of management and advisory fees. The term core typically reflects lower risk investment strategies, utilizing low leverage and generally represented by equity ownership positions in stable U.S. operating properties. Funds are weighted equally, regardless of size. While funds used in this benchmark have characteristics that differ from a REIT advised by Ares Commercial Real Estate Management LLC (ACREM) (including differing management fees), ACREM believes that the NCREIF ODCE Index is an appropriate and accepted index for the purpose of evaluating returns on investments in net asset value (“NAV”) REITs. REITs advised by ACREM have the ability to utilize higher leverage than is allowed for the funds in the NCREIF ODCE Index, which could increase REITs advised by ACREM's volatility relative to the NCREIF ODCE Index. An investment in a real estate investment trust (REIT) is not a direct investment in commercial real estate, but rather an investment in a REIT that owns commercial real estate. In some cases, periodic distributions from a REIT may exceed earnings and may be subsidized by borrowed funds, advances from affiliates, offering proceeds, and/or include a return of investor principal.

[5] As of March 31, 2020.



Ares Wealth Management Solutions, LLC, Distributor | Member FINRA | 518 17th Street, 17th Floor | Denver, CO 80202
866.324.REIT (7348) | BlackCreekCapitalMarkets.com

TL-5675-1221C 1222