Considering Cap Rates in Miami Area Commercial Real Estate

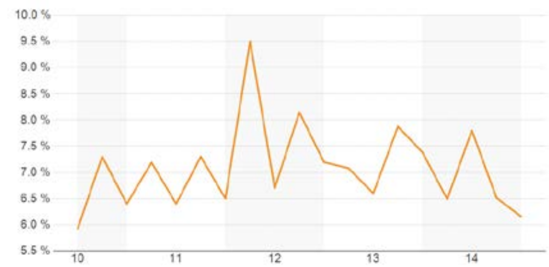
By James Hawkins | March 25, 2015

Commercial real estate investors and professionals tend to discuss cap rates like bond yields, frequently losing track of the underlying risk premium and growth potential factors that drive them. In a city like Miami, on the radar of global investors for its potential, this misses much of the story.

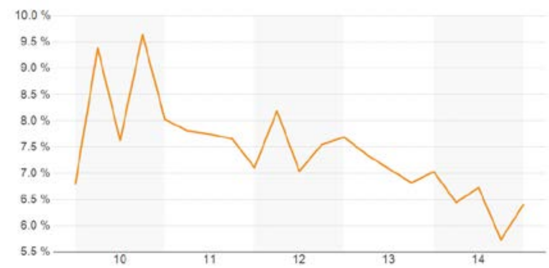
Cap Rate = Net Operating Income / Price

A cap rate (capitalization rate) is the net operating income of a property divided into it valuation, and thus moves inversely to price. The term is frequently used as a metric for a purchase or sale, with averages used for broad measures of the market. However, investors purchasing commercial property consider not just current return versus fixed income investments, but also potential changes in market value and income. Thus, a cap rate is a reflection of current income required by investors to justify the risk and lack of liquidity of investing in property, adjusted for other perceived gain or loss potential in the property, i.e. changes in income and value.

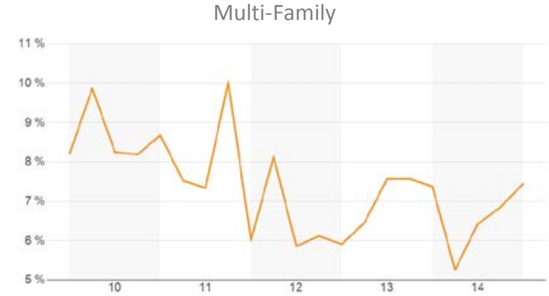
Miami-Dade Cap Rates



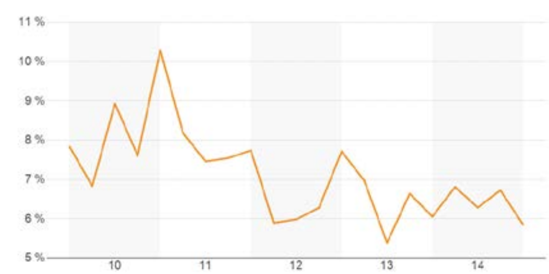
Industrial



Multi-Family



Office



Retail

The first part of this, the risk premium, tends to be more actively considered, with higher credit tenants justifying low cap rates. It is the growth potential aspect that frequently gets lost, as property to property valuation considerations by many real estate professionals and investors tend to be more about risk differential. They tend to consider cap rates as simply a risk free rate of return plus some risk premium, when conceptually they would be better served to also consider growth as a reduction to the cap rate:

Cap Rate = Risk Free Rate + Risk Premium – Income Growth

Cap rates are frequently considered versus bonds and other fixed income instruments, but consider this relationship in different interest rate environments. Higher rates tend to be in more inflationary environments, and inflationary environments generally provide additional returns to commercial property owners in the form of rent increases and appreciation. This inflationary benefit, which is not reflected in cap rates given that they only measure returns from current net operating income, tends to cause cap rates to be sticky compared to interest rates overall, with some analysts estimating approximately half of interest rate increases typically absorbed into cap rates.

Cap rate spreads versus risk free rates are currently at somewhat high levels historically. Thus, current returns from net operating income are notably higher than that offered by fixed income investments. This higher spread may also indicate that the spread has additional cushion, i.e. "room to give" such that cap rates may absorb more of interest rate increases than otherwise. On the other hand, it could instead be discounting concerns about risk of a decline in economic activity and its potential negative effect on net operating income, the numerator of the cap rate formula.

As for Miami specifically, many professionals and prognosticators would describe its potential growth as superior to most established markets. Given this, it is ever more important to consider growth expectations when evaluating cap rates on properties. The area's increasing global relevance, as combined with its geographic constraints, with the Everglades on one side and the Atlantic on the other, would seem to point to higher valuations over time. Offsetting this perceived potential are concerns about overbuilding, particularly given the area's history of booms and busts, with one of the more significant busts so recent it feels like only yesterday.

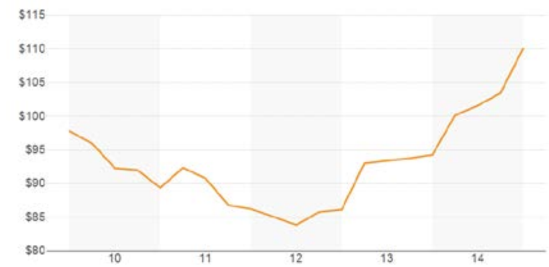
Cap rates, in any case, don't tell the whole story. They are simply a measure of the current return of a property at some given price. If NOI (net operating income) remains unchanged, a lower cap rate means a higher valuation, and vice versa. That is all well and good, but NOI never remains the same. Assuming a constant cap rate, a property's valuation changes proportionate to the change in NOI. Expectation of NOI growth, generating not only higher levels of income but also anticipated value increases, is a principal reason for most commercial real estate investment. Given that cap rates are relatively sticky versus interest rates, it seems more sensible to concentrate on NOI growth expectations, with expectations for rental rates being the biggest driver of this, than interest rate expectations. The heart of commercial real estate is the rent.

People frequently look for a time to buy or sell. However, commercial property investors are a savvy lot, and for every seller there is a buyer. One investor may find a set of returns, both from current net operating income and growth expectations, satisfactory for the perceived risk and lack of liquidity, whereas another may prefer to forgo such a return to have liquidity for special situations that may arise. One is a buyer, the other a seller, yet both are correct. Thus, for those who wish to know whether to buy or sell, the answer is the proverbial "yes."

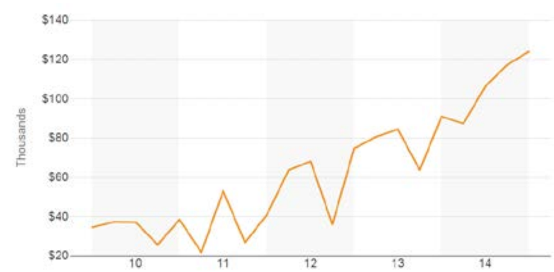
For more information about cap rates, including links to reports detailing how cap rates behave through cycles, visit:

HawkinsCRE.com/caprates

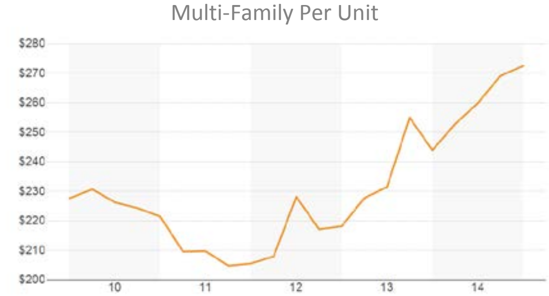
Miami-Dade Asking Prices



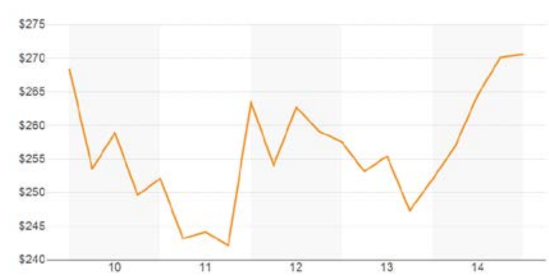
Industrial PSF



Multi-Family Per Unit



Office PSF



Retail PSF

Cap rate charts courtesy of CoStar.