Real Estate Research Institute

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Title: **Efficient Capital Markets with Predictable Asset Returns: Evidence from Private Commercial Real Estate Returns**

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RERI is a not-for-profit organization dedicated to bridging the gap between cutting edge academic research and the practice of commercial real estate investment. Each year, RERI funds research projects that have been determined to be both academically rigorous and of value to practicing real estate professionals. The following provides a brief overview of one of these research projects; please see the RERI website at www.reri.org for full research papers, as well as more information on RERI.

This paper examines the relationship between the going-in cap rate on properties and their subsequent returns. For real estate investors this is an important issue; investors constantly grapple with the implications of targeting high versus low cap rate properties. While higher going-in cap rates will generate higher current income, the conventional wisdom is that, all else equal, they will tend to show lower income growth (and therefore appreciation) in the future – recall that a cap rate can be represented as the required return minus the future growth rate. Whether the higher income return is enough to compensate for lower appreciation will determine whether total returns to high cap rate properties are lower, higher, or the same as lower cap rate investments. The paper examines this question empirically, presenting results for the average property.

To answer the question, the author makes use of property level data from NCREIF. After applying various filters to omit properties with errors or missing values in their data, the final sample consists of 2118 properties acquired between 4Q1999 and 4Q2014. The eventual IRR of each acquisition is then calculated; using the actual holding period and actual sale price for those properties that were eventually sold, and using a five year holding period and the appraised value at the end of five years for properties that were not sold. Going-in cap rates are then calculated for each property based on acquisition price and the subsequent four quarters of income (an alternative version is also tested, using four quarters of gross rental income, with similar results), and then related to the IRRs. To compare cap rates to growth, the author examined the five year growth in net operating income (NOI).

The results show that, as conventional wisdom suggests, higher cap rates are associated with lower future growth. The author is able to quantify this relationship, finding that a cap rate 100 basis points (bp) higher is associated with future NOI growth that is, on average, 148 bp lower. Looking at future returns, the paper shows that properties with cap rates 100 bp higher have, on average, IRRs that are 97 bp higher. So, despite lower growth, acquisitions of high cap rate properties return more on average. A regression framework is then used to show that the basic results still hold when controlling for property type, metro, and time period.

Of course, these results are for assets on average, not for all properties; there certainly may be cases where high cap rates result in lower returns and vice versa. This is especially important to keep in mind because the author does not distinguish between value-add investments and stabilized properties in examining the effect of higher or lower cap rates. Nevertheless, the finding that high cap rates tend to be associated with higher returns, despite lower growth, is an interesting and important one.

However, there is no free lunch. This paper also examines the relationship between going-in cap rate and future risk of the investment, and the results show that higher cap rates are associated with higher average risk (where risk is measured by the beta of the property with respect to the equity market).

The author interprets his results in terms of the informational efficiency of the real estate market; pricing for properties, as embodied by cap rates, incorporates prospects for future returns and risk and hence properties are priced “correctly” in some sense. However, I believe the real value of this research is not in its implications for market efficiency, but rather from a practical investment perspective. High cap rate acquisitions tend to have both higher returns and higher risk (at least as measured with an equity market beta); this contributes to investors’ understanding of the trade-offs between current income and future appreciation.