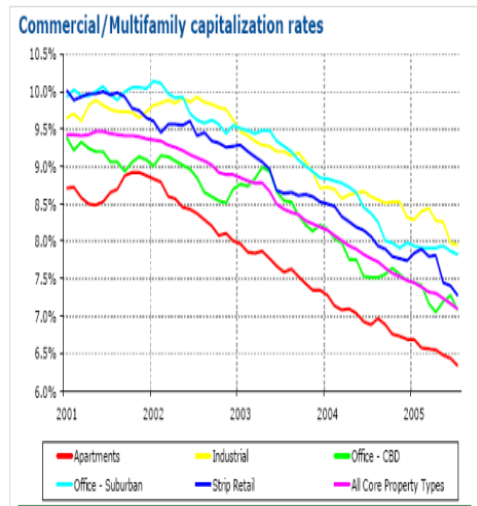
A 2012 Re-Evaluation of Real Estate Asset Valuation Methods©

Investing In Real Estate, seems to be the last thing on consumer & media lips these days, doesn't it? Where are the halcyon days when real estate defied financial gravity? Wasn't it just a few short years ago that individuals and institutions were in a buying frenzy scooping up second and third *"investment"* houses, skyscrapers, and anything else that resembled real estate got financed at lightning speed; regardless of the property's economics. I personally did not purchase any income producing properties and vehemently advised my family, principals, partners, and real estate students to stay away from acquiring property during this unprecedented boom phase of the real estate market cycle from 2002-2006.

Now as many sidelined equity investors appear poised to re-enter the real estate investment arena questions of valuation methods come to the forefront. A comparison of two cash flow valuation methods deserves attention. The most popular method is *Direct Capitalization* followed by a more complex *Discounted Cash Flow* (DCF) analysis method. The main difference between the two is that the capitalization (cap) rate is derived from the market, and the DCF is individual investor derived. To gain perspective let us consider the following:

Cap rates skydive 2002-2006



What was the effect of skydiving cap rates? As the chart clearly demonstrates asset values soared and rates of return plummeted. Easy access to capital bid up real estate values higher and higher to unsustainable levels as investors paid premium pricing on all core property types from 2002-2006 for a stream of NOI that was roughly the same as it was in 2001.

Ultimately as cap rates begin to climb investors who purchased during this boom phase of the cycle will experience reversals, unless they have the capacity to hold onto the property through the next long run expansion of real estate values, which is probably not before the next decade is out.

Fortunately, the conceptual frame work of real estate investment valuation doesn't change even through drastic ups and downs of the real estate market cycle, it stands as a faithful guide to direct intelligent investors in the correct investment strategy to pursue during any phase of the market cycle: buy, sell, refinance, or hold. Since the macro economy remains stalled in recession the lack of robust market sales data compounds the difficulty of obtaining reliable cap rate information going forward.

DCF to drive future investment decisions

Cap Rate or DCF

In an uncertain or volatile market the DCF stands out as an analytical tool, because it states that "today's value of an investment property is exactly equal to the present value of its future cash flows, discounted at the equity investor's required rate of return."

Chiefly, the DCF sums up the cash flows, then calculates a Net Present Value (NPV) that directly answers the investor's most pressing question: "*What is the absolute maximum purchase price that I can pay for the desired property and still achieve my required rate of return."* In my opinion when equity is at risk the investor must place more reliance on the NPV of the cash flows, rather than the cap rate, because the NPV sets the target yield rate, based solely upon that individual investor's *opportunity cost*.

Since around 2008 there has been a dichotomy among commercial real estate practitioners. Will cap rates rise again or will they hover at current levels for the foreseeable future? Or has there been a new paradigm shift causing cap rates to remain permanently low? My response? No!

Cap rates will continue to rise and eventually return to historic levels for all core property types, because the reality is real estate assets are only over-valued or under-valued for relatively short periods of time, before returning to long run equilibrium pricing. Cap rates will once again accurately reflect investor perceptions of market conditions. However, in the short run, I advise that investment decisions be made primarily with DCF financial models; applying the individual investor's *discount rate* to determine the maximum purchase price to pay for any type of income producing property. ◙

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