

From the April 2012 Issue of Real Estate Forum **The Great Cap Rate Debate**

By Erika Morphy



Last year, as executives at StarPoint Properties considered the purchase of Parkview Terrace, an apartment building in Los Angeles, many factors went into the \$79-million purchase price it would eventually pay. This included the terminal cap rate—the cap rate the building would trade at if StarPoint were to sell it within the next five years. And that number was? An eye-popping—in some people’s opinion—100 to 150 basis points higher than today’s.

In fact, that’s the firm’s estimated terminal cap rate for any property it buys now, CEO and president Paul Daneshrad says.

His reasoning entails a complicated series of factors but boils down to the firm’s analysis that inflationary pressure will eventually push cap rates up, despite the Federal Reserve’s apparent goal of keeping them low. “We’re already seeing some inflationary effects in the economy,” Daneshrad says.

And so StarPoint has staked out its position in the perennial Cap Rate Debate. The commercial real estate industry has always, of course, engaged in such analysis: Will cap rates compress any further, or will they rise over the following months and years? However, now, as we appear finally to be on the brink of growth after two years of lackluster progress, such calculations are more important than ever.

There have been a number of economic indicators pointing to a strengthening recovery. Perhaps the most encouraging—and industry specific—was the Urban Land Institute’s recently released Real Estate Consensus Forecast.

The predictions were a grab bag of goodies for the industry. Vacancy rates are expected to drop in multiple asset classes by anywhere from 1.2% to 3.7%. Rents, meanwhile, are predicted to rise, by 0.8% for retail, to 5% for multifamily. CMBS issuance is expected to more than double and perhaps most significant of all, the

volume of all commercial real estate transactions will increase by close to 50% over the next three years to \$312 billion.

Many of these sales, if industry patterns hold true, will go on to trade hands again within five years. In short, the question of whether or not cap rates will compress or rise over the next few years is about to become relevant very quickly for an increasing number of investors. And like StarPoint, people will be placing their own bets.

And not everyone, clearly, would agree with Daneshrad's conclusions...

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