Commentary

Where are Cap Rates Headed?

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By **Joseph J. Ori** | August 27, 2024 at 05:08 PM

One of the key questions from investors in today's tumultuous CRE market is where cap rates are headed. Cap rates have expanded about 2.0% since the Fed began raising the federal funds rate in March 2022, although the transaction volume is down about 70% from normal levels. Many "hot" properties like industrial warehouses in the Inland Empire and Miami and apartments in New York, Tampa and Miami saw cap rates compressed down to the 3.5%-4.5% range from 2019 through 2022. As the economy continues to slow down and the Fed begins lowering interest rates this year and next, cap rates will follow but I don't see them getting back to the lows above.

I expect the federal funds rate to drop 1.0%-1.5% this year and 1.5%-2.0% in 2025. This will create a CRE mini-boom in the fourth quarter of 2024 and a big boom in 2025. There is a huge pent-up demand to do CRE deals as the entire market has been in purgatory since 2022. I expect cap rates for high-demand Class A properties, excluding office buildings, in the Sunbelt growth markets to average 5.0%-6.0% and Class B properties in these markets to average 6.0% to 8.0%. Class A/B office buildings in the top markets will average 6.5% to 8.0% and in the high-crime urban markets, 8.0% to 10.0%+. Many office buildings in these high-crime urban markets like San Francisco, are in such distressed states, that they will not trade at a cap rate, but at a price discount of 60%-70% off their 2019 value. For example, a 90,000-square-foot building at 955 Market Street in San Fransisco, sold a few months ago for a pittance of $6.5 million or about 10% of the prior sales price of $62 million in 2016.

The cap rate on a property can be calculated in two ways. The first is the actual or dollar cap rate determined by dividing the proforma net operating income of a property by the cost or value and the second, is by a cap rate formula. The cap rate formula is the risk-free rate plus a risk premium less the growth rate in rents. The risk-free rate used in the cap rate formula is typically the 10-year Treasury Note which I believe will drop to 2.75% from about 3.9% today by the summer of 2025. The risk premium has historically been between 3.0% to 10.0% and I estimate that it is about 7% today. If the average growth rate in rents is 2.5%, then the cap rate

formula will produce an average cap rate in the summer of 2025 of 7.25% (2.75% + 7.0% –2.5% = 7.25%). This is an average cap rate and needs to be adjusted further up or down depending on the location and type of property.

There is still over $200 billion of capital available in CRE private equity funds and lenders will be eager again to increase their loan books with new commercial real estate loans. Foreign investors will also be active; however, they may be constrained by their mostly weak economies and the rise in the value of the dollar.

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