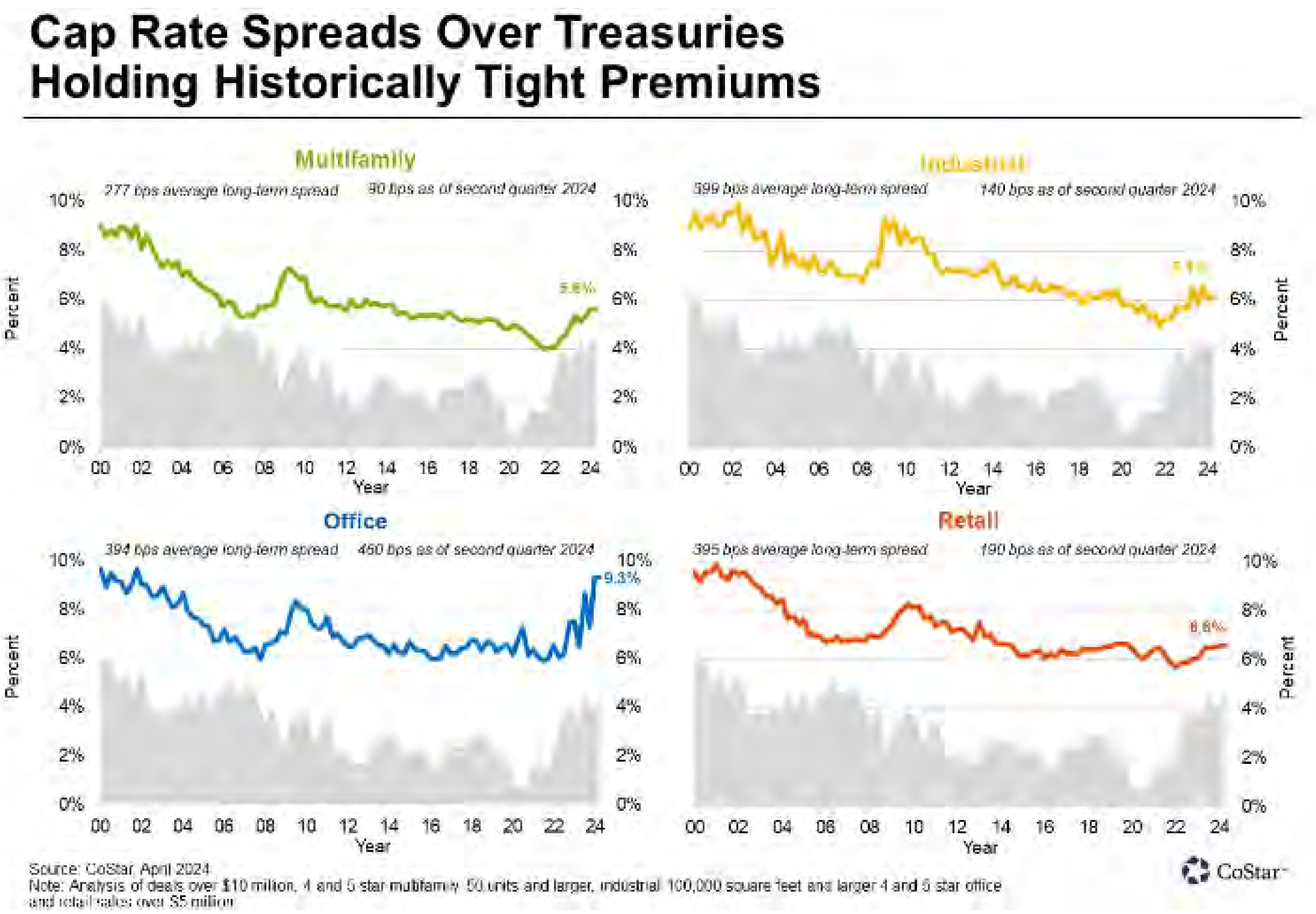
Capitalization Rates Head for Higher Ground

As Rent Growth Decelerates, Investors Shift Focus to In-Place Income



By Chad Littell

Expanding capitalization rates for property sales across the primary commercial real estate sectors shed light on evolving investor sentiment, especially as interest rates remain elevated and expectations adjust regarding property income growth.

During the post-COVID growth period, investors accepted lower initial yields, buoyed by optimism over the prospects for continued rent increases, which were expected to enhance capital gains over time. Yet, as rent growth decelerates across all property types, the emphasis among investors has shifted toward in-place income, especially in the office and multifamily sectors.

In the multifamily realm, particularly within the higher-rated four and five-star segments, those generally favored by institutional investors, cap rates have risen by about 160 basis points from late 2021. The current spread over U.S. Treasuries is a mere 90 basis points, significantly below the long-term average spread of 277 basis points since 2000.

This compression suggests that investors were anticipating significant rate cuts by the Federal Reserve that would depress Treasury yields and, in turn, lower cap rates. Recently, however, with the prospects of near-term rate cuts fading coupled with slowing income growth, investors seem to be reassessing the adequate premium over Treasuries for apartments.

In the industrial sector, cap rates are up about 120 basis points for larger-sized properties, those over 100,000 square feet. Yet, the spread over Treasuries remains less than half of its historical average at 140 basis points. Despite a surge in post-pandemic demand for warehouse and distribution space, there's a growing caution in this sector as absorption of new logistics developments slows. Historically, cap rates tend to stabilize as vacancy rates peak, which now seems delayed as new supply continues to come online.

In stark contrast, the office sector shows cap rates for four and five-star properties increasing as much as 300 basis points, pushing the spread over Treasuries to 460 basis points, 60 points above the historical norm. This significant widening reflects deep concerns over future income volatility in the sector as remote work patterns persist and traditional office demand fluctuates.

Cap rates in the retail sector display a distinct split: smaller deals under $3 million often produce yields near or slightly above Treasuries, suggesting a cash-buyer dominance, whereas larger transactions are seeing spreads of about 195 basis points over Treasuries, half the long-term trend. Whether an investor requires a premium over the risk-free rate can often highlight the influence of debt when buying commercial real estate.

These sector-specific variations in cap rates underscore the perceived risks and expectations for sustained rent growth and pre-emptive rate cuts. Economic growth and inflation data will be pivotal for the Treasury market in the coming months. If the Fed holds short-term interest rates steady due to inflationary pressures, rising Treasury yields could suggest higher future cap rates. Conversely, should the Fed cut rates, it will be crucial to discern whether this was due to falling economic growth (bad) or inflation (good).