

ORG Insights

Candid Real Estate Investment Industry Observations by ORG Professionals

The *Wall Street Journal* recently published an article highlighting the movement of many large pension funds toward investments in “core trophy properties” in order to reduce risk in their real estate portfolios. This strategy shift followed dramatic losses many investors suffered in opportunity funds and other high risk investments during the Great Post-Lehman Recession of 2008 and its bloody aftermath.

The large pension fund managers chasing these “trophy core properties” in select gateway cities are largely competing for many of the same assets at breath taking prices. Some industry advisors have been leading this movement and have indicated that there is \$9 billion on the sidelines seeking the perceived security of investing in such coveted assets. This migration to core has coincided with a drop in capitalization rates to amazingly low levels, reaching 4.5% - 5.0% in certain markets and property types (e.g., apartments in numerous cities and office in Washington, D.C. and Manhattan), similar to the low cap rates that existed in late 2007 before the major correction in the market.

ORG strongly believes this price level may leave core investors with disappointing returns. Why? How can this be? Proponents of the strategy to purchase trophy believe these are the safest and most insulated markets, with prices still 20% or so off their peaks and below replacement cost, with no new construction (except multi-family).

Why is ORG so concerned about this strategy? As George W. Bush once said, it is a plan based on “Fuzzy Math.”

Let’s review some simple math calculations. The difference in value between a property acquired at a 4.5% cap rate and a 6.5% cap rate is a whopping 44%. In order to achieve parity in value, significant rent growth must be achieved in the 4.5% cap rate property in what appears to be a slow growth environment for the foreseeable future, accompanied with the exit cap rate risk that must be achieved to generate returns consistent with investor objectives.

To further the concern, consider two examples.

If property A is acquired at a 4.5% cap rate, increases net operating income by 3% compounded per year for the next ten years, the unleveraged IRR would be approximately 5.7% using a 5% exit cap rate. If the exit cap rate were 6%, the property would generate a 4.2% IRR and 2.9% IRR at a 7% cap rate.¹

In comparison, if property B is acquired at a 6.5% cap rate, property B is essentially acquiring the same cash stream as property A, but at a 44% discount. If property B has income growth of only 2% per annum and realizes an exit cap rate of 7.0%, the 10-year IRR is 7.4%.

Can high quality core real estate be acquired at a 6.5% to 7.0% cap rate with moderate growth potential? ORG believes there are core opportunities that offer attractive risk adjusted returns for true core investors looking today for low risk and predictable cash flows.

ORG recommends that investors carefully understand the risks inherent in core today and challenge the valuation methodology managers are using to justify core acquisitions and valuations.

Be very cautious of the following phrases justifying these price levels:

- “It may be expensive, but it is great real estate.”
- “But it is significantly below replacement cost.”
- “We are just buying at the market.”
- “There is no new development. Rents have to spike.”

We welcome and highly encourage your comments.

¹The IRR calculations for property A and B both assume 80% of the property NOI is distributed each year. Office properties will likely have lower cash flow and apartments and industrial may have slightly higher pay outs.

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