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THE INVESTOR HUB

Cap Rates Remain Surprisingly Stable

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Americas Industrial Office Multifamily Retail Article



The fair-market value of any asset is what a buyer and seller are willing to accept at any given time. The three basic components of commercial real estate value—capitalization rate, current net operating income (NOI) and projected NOI—fluctuate based on macro-economic conditions: the profitability of leases with existing tenants and the likelihood and cost of securing new ones.

The bad news in the COVID-19 era is that at least two of these factors (current and projected NOI) are at risk, causing a pause in investment activity for most commercial real estate assets. The good news is that cap rates have remained relatively stable. CBRE's just-released [Cap Rate Survey Special Report](#) shows that cap rates for most industrial, multifamily and office assets have remained at pre-COVID levels and have gone down for the best assets, particularly industrial.

How is cap rate stability possible in such a fluid environment? One reason is that investment volume is extremely low due to a decided mismatch in buyer and seller expectations. Some 84% of CBRE's Cap Rate Survey respondents say that sellers are unwilling to offer discounts while 61% of buyers expect them. In the absence of closed deals, the level of transparency into market cap rates is low. In short, the survey is a bit more speculative than past ones in which many more comps were available.

While investment volume remains subdued, the number of signed confidentiality agreements has risen sharply. This demonstrates that equity capital markets are deep and liquid, which will counteract much of the broader market risk and volatility.

Cap rates are less stable for retail and hotel assets. In fact, CBRE has omitted hotels from its recent survey because the sector is simply too volatile—and closed deals too few—to accurately measure. Some recent hotel sales have been discounted by as much as 30%.

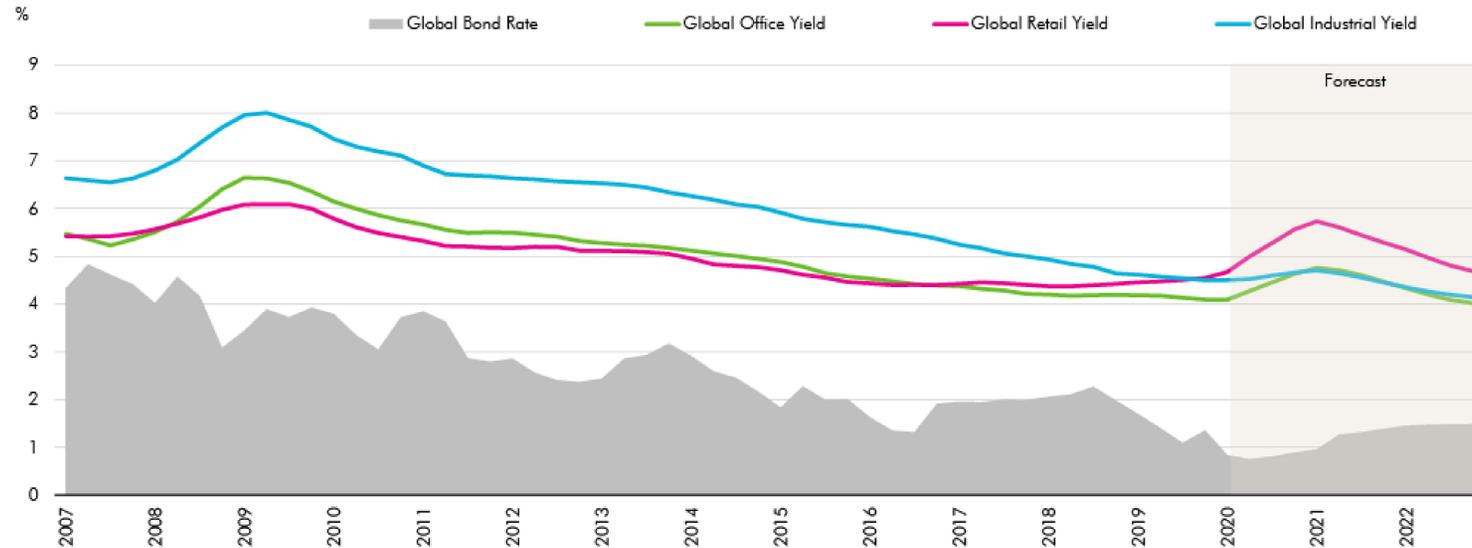
Some may argue that if projected NOI is stable or lower, there may be more cap rate expansion than what appears in the survey. Some would also argue that if there were more forced sales, there would be a rise in cap rates. But a forced sale may not reflect a willing seller, and therefore does not accurately reflect fair-market value. While there is validity to both these points, CBRE forecasts that cap rate expansion will be much more limited in this downcycle than it was in the past. This is primarily because of massive equity market liquidity and, perhaps more importantly, the Fed buying

mortgage and other bonds. This has created more positive leverage (the difference between the cap rate and the cost of debt) than in almost seven years, which further limits upward pressure on cap rates.

While overall commercial real estate values will decline due to challenges to current and projected NOI, relative cap rate stability vs. prior cycles will provide some good news in an otherwise difficult market.

YIELD EXPANSION WILL BE MODERATE

Composite yields by major asset types



Source: CBRE Research, Q2 2020

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