

Breaking Ground

COMMERCIAL REAL ESTATE TRENDS

January 2006

Investment Return (CAP) Rates Reach Record Lows

Investor's scheduled rate of return for investment properties, or CAP Rates, have reached record lows nationally as the commercial real estate market continues with a strong forecast for the foreseeable future.

"The CAP Rate as represented by the recorded sales of investment property nationally are historically low, which provides evidence of the strength of the investment real estate market, according to Joseph Perry, President and CEO of Perry Group, Ltd.

"This means that the expected return in investment for buyer's as they purchase property is lower than usual which means higher prices for properties on the market".

The lower the CAP Rate the less the investor is expecting to yield as a return on his investment which equates to a higher sale price for the seller. According to Perry, a 8.5% CAP Rate on a quality investment property should sell in extremely quickly.

"We are seeing CAP Rates as low as 6% in dynamic markets. This is equal to the cost of capital, which indicates that the investors are choosing real estate investments with relatively low comparative returns in exchange for the opportunity for appreciation in a marketplace, depreciation on paper, and often the capital gain shelter provided through Starker Trusts. Leveraged deals are especially interesting when the cost of money equals the return on investment", said Perry.

The national average for Class A and B properties ranges from 7% - 8%. The expectation by industry experts suggests a stabilization of these yields over the next year. Interest rates, while climbing, are still low enough to encourage investment in new developments and the availability of capital is unprecedented in recent history.

"Certainly there is the chance of correction in the industry that will create regret for certain investors, but a wholesale recession due to overaggressiveness is less likely. Many investors remember the 20% Prime Rate and lenders and regulators are much more analytical these days", said Perry.

How to Calculate a CAP Rate

A CAP Rate, the traditional measure of return on investment for commercial real estate, is calculated by dividing the Net Operating Income (after operating expenses but before debt service) into the total investment cost.

Example:

Gross Income (annual): \$180,000
LESS Operating Expenses* \$80,000
= Net Operating Income (NOI) \$100,000

Sample CAP Rate of 7.25%
 $\$100,000 / .0725 = \$1,380,000$ Value

Sample CAP Rate of 8.50%
 $\$100,000 / .0850 = \$1,176,000$ Value

The CAP Rate represents the Buyer's expected rate of return, therefore the higher the CAP Rate, the lower the sale price realized by the Seller.

**includes all recurring or scheduled operation expenses except but not principal or interest payments.*

NATIONAL AVERAGE CAP RATES (2005)

<u>Property Type</u>	<u>Average CAP Rate</u>
Retail	6.7% - 9.0%
Industrial	7.0% - 9.9%
Office	7.0% - 10.8%
Multi-Family	6.0% - 9.3%

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