A Better Way for Cap Rates

Capitalization Rates on Real Estate are great. One number says it all…or…nothing at all. Translating Net Operating Income (NOI) of a piece of Real Estate to purchase/sales price is illuminating. But then again, the one number is a combination of the Risk-Free Rate of Return and a Risk Premium characterized by the specific piece of real estate.

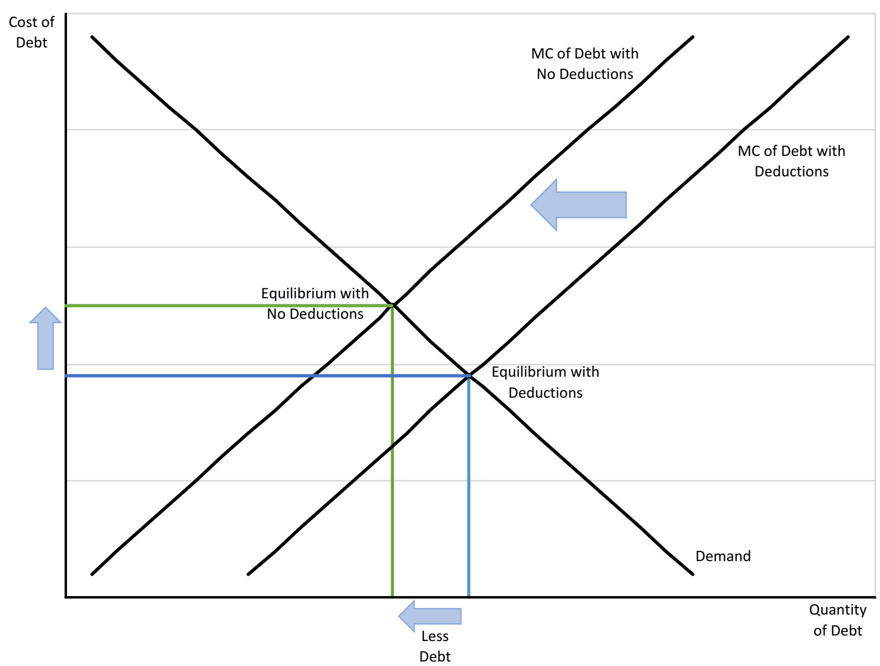
There are also different cap rates. For example, there is a going-in Cap Rate, i.e. the sales price today, and there is a terminal Cap Rate, i.e. the future sales price based on future NOI.

The future NOI is based on your hard work and the multiple exogenous factors that effect a piece of real estate. There may be a "Better Way" to look at Cap Rates in the future. NOI is calculated before financing costs, i.e. interest carry and any loan amortization.

Soon Congress will begin to form legislation on the Republican Party's "Better Way" which includes, among other items, **the elimination of the deductibility of interest payments** by businesses, including real estate. **This change, *ceteris paribus,* will have a detrimental impact on cap rates for real estate.**

The diagram below illustrates the impact of the non-deductibility of interest carry on the marginal cost curves of a deal. With no interest deductibility, all of the interest costs of the deal are increased. Average costs increase. Marginal costs increase. This is illustrated by the supply curve shifting to the left, i.e. **at every level of debt demand the cost of debt is higher.**

The diagram below also illustrates that the quantity of debt per deal will also diminish. This makes sense since the marginal cost of debt increases. Therefore, leverage ratios would fall, and high loan-to-value deals would become rare.



Although the risk-free rate could remain the same, the risk premium on a real estate deal would increase, since the cash flows from the real estate could cover debt service, but may not be sufficient to cover any tax bill.

The non-deductibility of interest carry on the deal, by itself, would increase cap rates for real estate, because the risk premium portion of the constructed cap rate has increased. Additionally, the marginal cost of higher risk-free rates is not offset by any tax savings, leading to **more sensitivity of real estate values to changes in interest rates.** Congress is just kidding, right?