



Institutional Real Estate: Attractively Valued on a Relative Basis

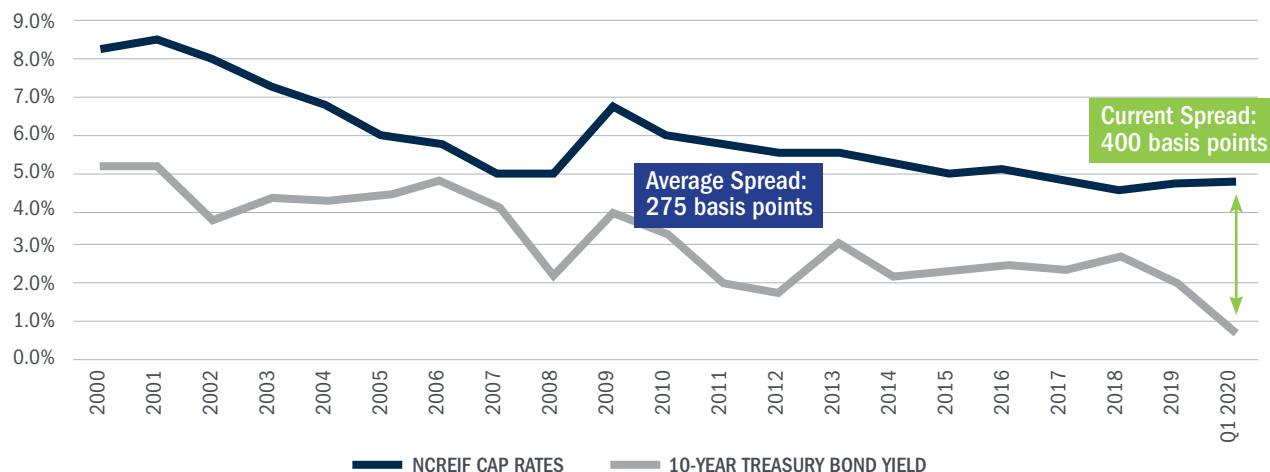
Warren Buffett was once asked the most important data point when trying to evaluate future investment performance. His response: “interest rates”. All investment valuations are relative to each other. Investment capital allocates based on the relative valuations of various asset classes and investment opportunities. The ultimate reference point for relative valuation is what is referred to as the risk-free interest rate, the 10-year U.S. Treasury Bond yield. This is because its interest payments and return of principal are backed by the full faith and credit of the U.S. Federal Government. It is considered the safest investment in the world. Thus, all potential investments, yields, and returns are priced at a premium to it based on their risk profiles.

For example, when investors examine stock prices, they look to price/earnings ratios and other key valuation metrics relative to the risk-free rate of return. Bond investors price corporate bonds as a premium to the risk-free rate with projected higher returns corresponding to higher risk. Higher rate spreads entice investors into an asset class as their investment risk is rewarded with potentially much higher returns.

Unique to real estate investing, a capitalization rate, or cap rate, is the yield of an unleveraged real estate investment. It is the projected net operating income in the first year subsequent to purchase, divided by the purchase price. For example, if an investor purchases a property for \$1,000,000, and the projected first year of income after operating expenses is \$50,000, the cap rate was 5%. Holding income constant, cap rates indicate value. Rising cap rates reflect value declines and falling cap rates reflect value increases. How do investors evaluate cap rates according to risk and potential total returns?

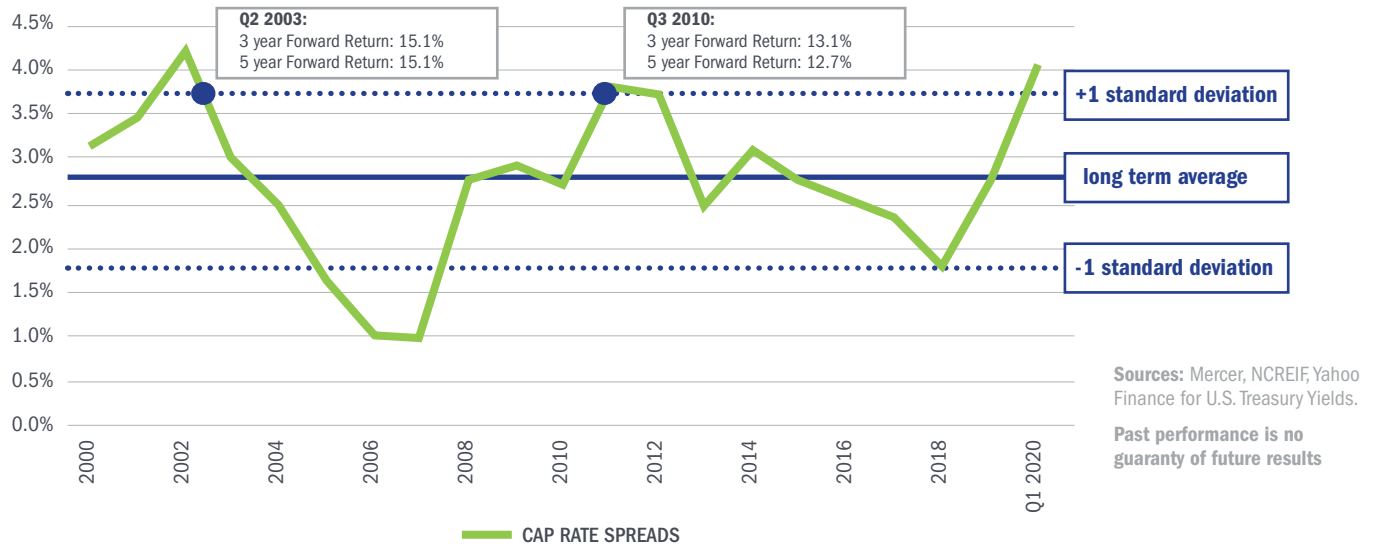
Astute real estate investors undertake a similar analysis called a cap rate spread analysis. A cap rate spread is simply the current average cap rate, or the yield of an unleveraged real estate investment, versus the risk-free rate of the 10-year U.S. Treasury Bond yield. Spreads near or above the longer-term average imply that real estate pricing is not overheated, as cap rates are not low relative to the 10-year U.S. Treasury Bond yield. The chart below reflects historical institutional real estate valuation cap rates and 10-year U.S. Treasury Bond yields.

Historical Cap Rates and 10-Year U.S. Treasury Bond Yields | 2000 - Q1 2020



As illustrated, current cap rate spreads to U.S. Treasury Bond yields are currently above long-term averages, a strong positive indicator for attractive relative valuations. Historically, during periods where cap rate spreads were well above (more than 1 standard deviation) the long-term average such as during 2003 and 2010, the following 3 to 5-year returns for institutional private real estate were also above its long-term average shown in the chart below.

Historical Cap Rate Spreads | 2000 - Q1 2020



While future performance of any asset class is uncertain, we believe the extraordinary cap rate spreads present in institutional real estate in 2020 will attract significant capital to the asset class which should bode well for its future performance outlook.

Risk Factors and Disclosures

All real estate investments have the potential for value loss during the life of the investment and the sponsor can make no assurances that any investment will achieve its objectives, goals, generate positive returns, or avoid losses. The Income Capitalization Approach (cap rate) is only one method of real estate valuation and may not be the most appropriate or accurate approach for all properties and all scenarios.

This paper is intended to be educational in nature and is not intended as investment advice. Unless otherwise indicated, the information provided herein is as of June 2020. Information contained herein is derived from market and industry data that were obtained from third-party sources and publicly available information. We believe that this third-party data is accurate and that its estimates and assumptions are reasonable, but there can be no assurance as to the accuracy or completeness of this data. We have not independently verified any of the data from third-party sources referred to herein.

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There can be no assurance that any investment strategy will achieve its objectives, generate profits or avoid losses.

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