Tumbling capitalization rates create a trap for valuers and analysts

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In the residential property market, estate agents and valuers have a serious problem in estimating the market value of a house. The reason for this is the phenomenon of galloping prices that invariably means that the historic comparable sales on which an estimate of market value is based, are outdated the moment they become available to market players.

This writer recently heard of a case where the owner of a townhouse had his house valued by three top agents in the neighbourhood. The average estimate was R450.000, and they were within R10.000 of each other. So the owner put his townhouse on the market for this amount. Within two days he had sold the property for R500.000 — because the first prospective buyer offered more than the asking price!

In the commercial and industrial property market a similar scenario is unfolding. Market rentals haven't moved by much yet, but capitalization rates — the market's rating statistic — have dropped quite considerably over the past year, depending on property type and region.

The accompanying table, from chapter 3 of this issue of *RR*, shows that over the past year regional centres' capitalization rates, for example, had dropped by nearly ½ a percentage point per quarter. In the current market, the implication is that if a property valuer were to use historic evidence without further adjustment, he or she is probably undervaluing the property.

Change in national capitalization rates in the last year*				
	Offices		Industrial leasebacks	Regional SCs
	CBD	Decentralized		
Qtr 2003:3	17,8%	13,5%	13,3%	12,1%
Qtr 2004:3	15,2%	13,0%	12,2%	10,4%
% point change	-2,6	-0,5	-1,1	-1,7
*Smoothed data was used.				

The main factors driving the steep decline in physical-property yields are:

- Long-bond rates are dropping on the back of declining inflation expectations. This allows listed funds — whose income yields now fall even faster than those of long bonds — to pay more for properties (i.e. buy physical properties in at lower capitalization rates) without diluting earnings.

- Equity, property's main competitor as an asset class, is still — albeit wrongly so — out of favour, and investors are concomitantly rushing into property.

- The rise of syndicators because of the sharp decline in interest rates. Research by RR shows that in some sub-categories of properties these companies represent a significant proportion of the total number of transactions, and their presence is undoubtedly depressing capitalization rates (see this issue of *RR*, chapter 4). These companies can afford to pay more than, say, listed funds because they retail their products to an unsophisticated market of retirees, widows or maybe even working professionals — investors who are oblivious to the inverse relationship between return and risk. These retail or end buyers are generally impressed if they can disinvest from the money market, where they may be earning 6%, and reinvest in a riskier syndicated single property where they are offered, say 10%. However, this is not to say there aren't sound syndicated property-investment opportunities out there — it all depends on the specifics, i.e. the trade-off between risk and return offered to the retail investor.

- Prospects for physical properties' earnings growth are improving, especially in the case of shopping centres.

Thus, in the current fast-moving market, valuers should carefully consider time-adjusting all evidence relating to capitalization rates to arrive at a more accurate rate as at the valuation date. In the case of RR capitalization rates, we recommend that the smoothed trend over the past four quarters be extrapolated by one quarter. As for capitalization rates from other sources, this extrapolation might be for an even longer period.

This brings me to the use of net asset values (NAVs) by analysts to judge if a listed property fund is fully valued by the market. Given the above trailing-capitalization-rate argument, it is evident that an NAV that is six months old (half-way through the financial year of the fund) is probably nine to twelve months out of date — depending on the age of the information used by the valuer and assuming the fund is revalued annually at its year-end. In this regard, bear in mind that in practice the valuation of a fund is often done a few months before the financial year-end, and the valuer is forced to use market information that is then available to him — which in turn could be a few months old.

Apart from the trailing effect created by the fact that capitalization rates are dated, we must also consider that the NAV is nothing but the sum of the individual properties' market values. And this figure is not directly comparable with the JSE-market capitalization, for two reasons:

- Firstly, by creating a portfolio (a bundle of properties, called a fund), the risk is lowered because the cash flow of the fund is less volatile than that of an individual property, and the fund consisting of grade-B properties would thus command a lower "capitalization" rate than an individual grade-B property.

- Secondly, by listing such a portfolio on the JSE, liquidity is added, which once again lowers the "capitalization" rate because the market is prepared to pay a premium for liquidity. The magnitude of this premium will evidently depend on the degree of liquidity of the specific fund. For instance, the larger the fund and the greater the "free float" (percentage of shares that are traded over a given period), the greater the premium.

We do not have a scientific way of measuring the combined (or individual) effect of these two factors (suggestions are welcome!), but combined they could easily be responsible for the fund trading at a premium of 20% to the up-to-date NAV. Add to this the trailing effect of historic evidence on capitalization rates in a fast-moving market like the present, and the reader can appreciate that a JSE-traded premium of 30% to NAV can easily be explained. And this seems to be the situation at present with many a fund. ∎