

AREUEA Conference Paper

Online Abstract Submission Summary

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Title: Apartment Cap Rate Spread Decomposed

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Abstract: With cap rates at or near historical lows, a question that both investors and researchers often ask is why commercial properties are trading at such high prices. How much of the price increase is due to our prolonged period of low interest rates, and how much is due to the flood of money chasing real estate investments? Has there been a disconnection between real estate pricing and market fundamentals? Or is it true that, as some argue, real estate as an investment class has become less risky? Significant advancement has been achieved in understanding the dynamics of cap rate movements as an increasingly large literature has emerged.

In order to better understand cap rate movement, we decompose apartment cap rate spread over risk-free rate into local-fixed and time-variant components in the spirit of Sivitanidou and Sivitanides (1999). In particular, cap rate spreads are treated as the risk premium explained by the variation in both time-variant national capital market movement, and both local-fixed and time-variant local real estate market traits. NCREIF implied cap rates are used for a selected number of metros in our estimation. Our preliminary results find no evidence for the disconnection between real estate pricing and market fundamentals. Instead, we find that cap rate spread is largely driven by local market factors, both fixed and time-variant ones. Furthermore, apartment investors are shown to be myopic than forward-looking, which is in sharp contrast to the mean-reverting efficient market behavior as described in Corcoran and Iwai (2003). Finally, efforts are made to identify the relationship between cap rate spreads and the time-variant local capital flow by incorporating metro level transaction volume data from Real Capital Analytics. Sensitivity analysis is performed and implication discussed.

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