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The Elusive Cap Rate
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Finding the elusive cap rate in today's transaction market is the biggest challenge commercial appraisers face. And, it is not simply a U.S. problem, it permeates the entire global appraisal profession.

The solution to the challenge is rooted in traditional appraisal methodologies and is, in fact, right under our collective noses.

Active/potential sellers and buyers have always been the source of cap rates and this reality has not changed. If anyone truly knows cap rates, it is those who are actively seeking to dispose or invest in commercial real estate assets. Without that knowledge, there would be no transactions. Even if some potential sales do not materialize because there is no meeting of the minds, the potential sellers and buyers know their cap rate comfort level. In those situations, the truth is likely somewhere within the bid/ask gap.

Taking the pulse of active/potential sellers and buyers has always been the hallmark of good appraisal research and it has not changed just because the market is "distressed." Appraisers continue to research, verify, and use the limited number of current sales but find themselves with too few cap rate data points to reasonably support their conclusions.

Here's the solution! Go back to comparables that are a little dated, maybe one to two years prior to a valuation date. Reconnect with participants to those transactions and get their input on how they would do the same transactions on the appraiser's date of value using the same property, same historical performance characteristics, existing leases, etc., but a different economy and leasing and capital market conditions. The essential questions are how would you underwrite the deal and what cap rate would likely result as of the appraiser's valuation date?

In doing this, the appraiser does not "create new comparable sales" but instead completes a highly targeted local "investor survey" of transaction participants who have already invested in the local market and are quite familiar with current conditions. This method of extracting useful, supportable current cap rates takes the place of reasoning to a current cap rate using older sales with some narrative discussion of how distressed economic and real estate market conditions lead the appraiser to conclude with a higher cap rate of X. What would the appraiser's client prefer – the appraiser's opinion supported by the opinion of seasoned investors in the local market, or the appraiser's subjective opinion based on broad references to distressed economic and real estate market conditions. The answer is obvious.

The technique described above may be new to many appraisers, but I and a few others have been using it since the 2001 recession. It reflects standard appraisal methodology which is based on getting to investors "in the know," "taking their pulse," and "picking their brains" to support valuation assumptions and pricing. What could be more normal for an appraiser!