

Valuing Industrial Assets: When Cap on Market May Not Be Enough

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WHITE PAPER



Introduction

When buyers, sellers, brokers, asset managers and other market participants discuss transactions and valuations, often certain metrics are cited to provide context. This is because real estate differs across vintages and markets, and to compare apples-to-apples, reference points must be created. Historically the transaction-derived capitalization rate, or the yield generated by the Net Operating Income (either trailing or pro forma), known as the “cap rate,” was the most logical and relatable number to reference.

In the industrial space this has always been relevant due to the nature of the assets, which are typically triple net leased (“NNN”) to one or a few tenants. Simple usually works. However, after the conditions of the past few years, which saw an extraordinary increase in rents followed by a spike in interest rates, the standard cap rate as a reference point is not the reference it once was.

Enter, the “Cap on Market,” a similarly simple metric which is easily sourced from transaction data, and represented as ubiquitous across properties and markets. Cap on Market is easily calculated by dividing the assumed market rent per square foot by the value per square foot. Unlike a transaction cap rate, where price and contract rent are utilized, here one input is fact (price) and the user’s assumption of market rent still makes the metric easily sourced. This data point has become more shared and referenced in the last 18 months as transactions close in the post rate-rise environment, and market participants seek to compare their deals/assets to those that are trading. Unfortunately, the reality is, it often doesn’t work or translate back to how investors approach a deal -- not, at least, in the way most are using it. It fails in the primary task of being universal and translatable, and it boils down to the details. As we will present in the following pages, components such as remaining “weighted average lease term” (WALT) and the spread between market and contract are critical to understanding value in today’s market.

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Dig Deeper: Details Matter

The Situation

The industrial market has seen an influx of transactions in recent quarters. These transactions are being utilized as comparable sales to determine a reasonable fair market value. **The Cap on Market has emerged as a tool for some in the valuation world to compare and contrast value between assets. However, this metric can often be flawed, if quoted and applied universally across a portfolio.** Specifically, the Cap on Market metric does not account for the duration risk (lease term), yield risk (contract vs. market rent ratio) or terminal risk, in which nearly the entirety of the value is based on assumptions six to 10 years out and most of the value is tied to unassured aspects of the cash flow.

The duration risk in industrial real estate today is the single most important driver of price and value. When investors are establishing the price of an asset, significant emphasis is placed on the remaining WALT and the contract rent vs. market rent ratio ("rent spread"). Investors are showing, very clearly, pricing and preference for how they are assessing the duration risk in assets, particularly when there is a wide rent spread that results in very low yields over long periods of time.

Analysis

There are three primary scenarios in the industrial investment landscape today that are a byproduct of the market conditions of the past four years – a large run up in rents followed by a spike in interest rates. The three scenarios are:

1. Mark-to-Market Opportunity: Contract rents well below market rents and near-term lease maturity (i.e. 1 to 3 years).
2. Stabilized Deal/Asset: Contract rents generally in-line with market rents and a long-term lease (6+ years).
3. Long & Low: Contract rents below market (20%+) and a long-term lease (6+ years).

Transaction activity and subsequently price discovery is reasonably clear for scenarios 1 and 2. Scenario 1 often reflects a low year 1 cap rate that is in the 3.5% or 4.5% range, followed by a mark-to-market event in the first few years that generates a 5.5% to 6.0% or higher stabilized cap rate. Scenario 2 often reflects a 5.0% to 6.0% year 1 cap rate that is relatively stable and increases with the lease step. Both scenarios (1 & 2) are represented across the country repeatedly through increasing

transaction activity, in which there has been sufficient price discovery. Scenario 3 has seen little transaction activity to give guidance on price and value, but theory and time value of money can certainly provide a solid guide on what is reasonable (or more importantly, what is not reasonable).

Since the beginning of 2024 there have been a number of observed transactions with a more modest spread between market and contract rents but a longer WALT. These are trading with stabilized metrics, indicating that buyers and sellers are willing to come together at these economics on deals that are not stabilized, in the sense that rent is at market, but do not have a near-term opportunity. Unlike the "long and low" these are typically more recent builds with rents no more than 10% to 20% below market and are transacting at yields that are reasonably attractive (5%+) from an investment perspective; and financeable without eroding the entirety of the cash flow. As these trade with stabilized metrics we considered them in this category for our analysis.



CHART ONE and CHART TWO outline six transactions, and the corresponding Cap on Market. As depicted in these charts, the average Cap on Market of these transactions is 6.04%.

Question:

If tasked with valuing an industrial asset, is it reasonable to assume a Cap on Market of 6.0% is “the market” and should be applied to an asset regardless of the key data metrics (such as location, WALT, contract rent-to-market rent ratio, etc.)?

Answer:

Simply relying on the Cap on Market to support a value is inconsistent with how buyers and sellers are arriving at a price. Without the details, a material inaccurate value is a possibility. Remember, the details matter.

The Details:

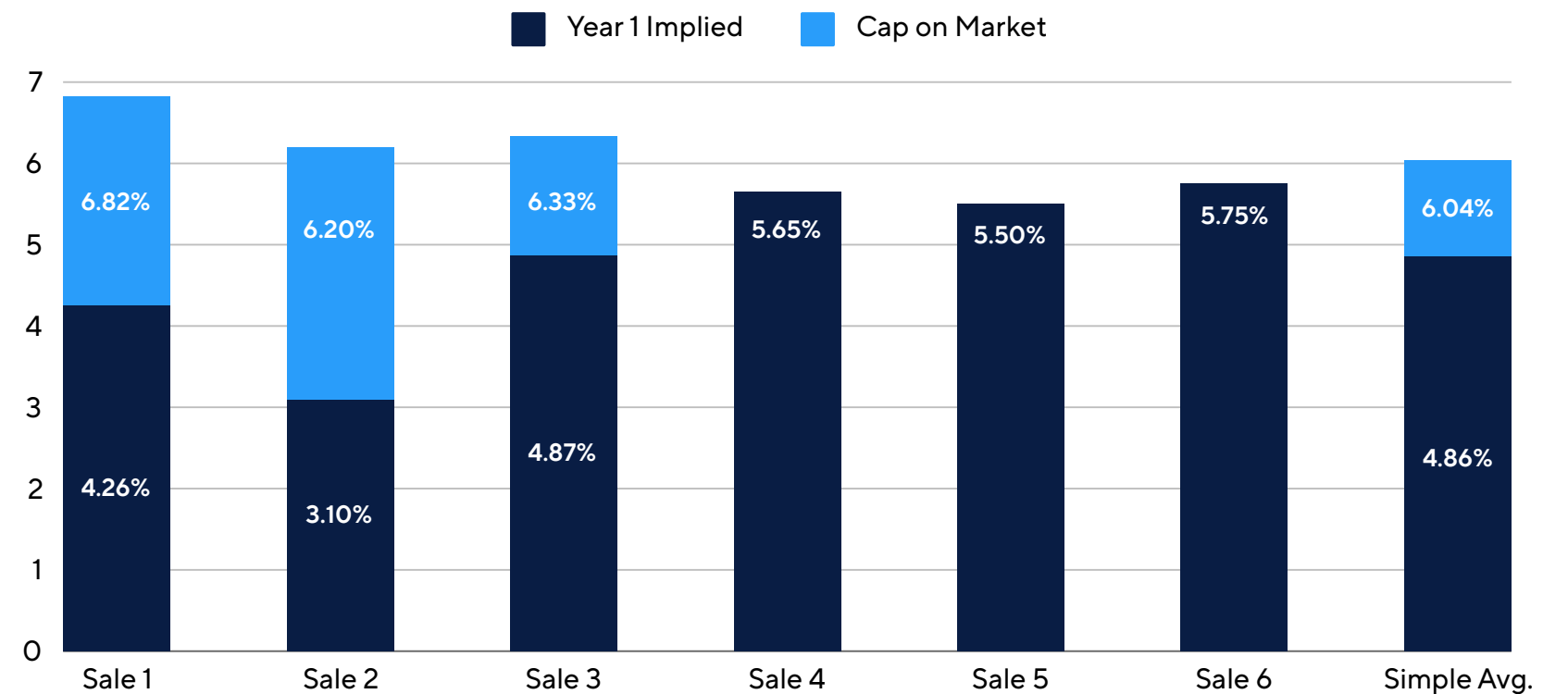
Additional details need to be considered in order to appropriately assess the six market transactions. When digging into the details, it is evident that these transactions demonstrate two of the three scenarios mentioned above - Mark-to-Market Opportunity and Stabilized Deal/Asset. Long & Low remains less represented in market.

These example data points demonstrate the dichotomy at work that is specific to cash flow (actual vs. hypothetical yield). Unlike a stabilized cap rate, the mark-to-market cap rate needs to be higher to account for the negative carry. The shorter WALT deals address this and resolve it in short order, making the differential minimal, but no less appropriate. Cross applying the Cap on Market from one group to the other would negate this market dynamic: the details matter. Buyers are adjusting for the duration and yield risk through a discount in the price relative to the stabilized price. The cash flow from contract rents cannot be changed, only the price, in order to produce yields (relative to risk) that are sufficient to the investor, either over the short or long term. By lowering the denominator (price), the Cap on Market produced from the sale in a mark-to-market situation is higher than those on stabilized deals.

CHART ONE

	Mark-to-Market Opportunity			Stabilized Deal/Asset		
	TX	GA	IL	AZ	GA	FL
Asset Count	1	1	1	1	1	1
WALT	2.5	2.0	3.0	10.0	9.5	9.0
Value PSF	\$99	\$118	\$172	\$108	\$131	\$106
CR/MR Ratio	0.63	0.50	0.77	1.00	1.00	0.95
Year 1 Cap	4.26%	3.10%	4.87%	5.65%	5.50%	5.75%
MR	\$6.75	\$7.32	\$10.89	\$6.10	\$7.21	\$6.10
Cap on Market	6.82%	6.20%	6.33%	5.65%	5.50%	5.75%

CHART TWO



Now What? Real World Application

Hypothetical Scenario

To further understand the details, consider the following hypothetical scenario.

An appraiser has been tasked with determining the value of a building, so they speak with a broker who was involved in the sale of the asset next door. This comparable is the same size and vintage as the subject and the broker indicates rents are “in the mid/high-\$5s” (similar to the subject) and the asset was priced at a 6.17% Cap on Market.

The Approach

Considering the similarities, is it reasonable to assume the Cap on Market represents an indication of fair value for the subject as well, and a willing buyer would execute on similar terms with the subject asset? Let’s test this theory and apply the Cap on Market to the subject asset in CHART THREE.

Utilizing comparable sales in this manner is foundational to valuation work. However, as mentioned before, details matter. In this case THE DETAILS paint a stark contrast between the two assets.

CHART THREE

	Comparable	Subject
Sales Price (psf)	\$227	\$227
Market Rent	\$14.00	\$14.00
Implied Year 1	2.53%	2.28%
Cap on Market	6.17%	6.17%
In-Place Rent	\$5.85	\$5.60
CR/MR Ratio	0.42	0.40
WALT	2.00	7.00

The Details —

While the neighboring sale was in a similar location, of a similar vintage and size, it differed significantly in the details.

- WALT: Both were leased at completion and therefore had similar vintage leases; the neighbor signed a 5-year lease which has two years remaining while the subject signed a 10-year lease and has seven years remaining.
- Contract Rent: Although the broker indicated rents were Mid/High \$5s, there was a \$0.25 difference in contract rents.

On the surface these differences appear minimal. However, they result in vastly different cash flows. As a result it is critical for the appraiser to consider the **negative leasehold adjustment**. To determine this adjustment, the appraiser should assess the loss rents due to the below-market lease, discounted back to today. For analysis purposes, we have assumed a discount rate (safe rate) of 4.0%, compensating the investor for all the risks previously outlined in the Long and Low.



As demonstrated in CHART FIVE and CHART SIX, the impact of the negative carry is more significant within the subject property given the lower contract rent over a longer period of time. In this example, the buyer who willingly accepted a negative carry of \$16.00/sf on the comp to achieve the desired return would instead have to swallow a \$63.00/sf negative carry. Details matter.

Taking this into consideration, [what is a more appropriate value and how do the economics present when comparing the two approaches?](#)

CHART FIVE

Negative Leasehold Analysis - Comparable		
Year	1	2
Market Rent	\$1,400,000	\$1,442,000
Actual Rent	\$585,000	\$602,550
Rent Loss	\$815,000	\$839,450
Safe Rate	4.00%	
NPV	-\$1,646,174	
Negative Carry	-\$16.00	

First the spread between contract and market rents along with the WALT need to be taken into consideration, as they were not in the above example. An investor willing to take on such a significant period of negative carry before realizing a mark-to-market scenario will want (and need) to be compensated for the risk they are taking. Historically longer lease terms meant protection in real estate and lower yields. All else equal (contract rents aligned with market rents), this remains true. But relative value comes into play, and with a government bond yielding roughly 4%, investors have options.

With a cash flow return that is low for a long period, a larger portion of the overall return is pushed to the reversion. This is occurring 10 years in the future, and the risk associated with time outweighs the lease protection. A typical investor would require an appropriate overall return to account for the backloaded risk. Instead of blindly applying a Cap on Market to estimate value, the appraiser should be analyzing the cash flow and estimating

what would be a realistic risk adjusted return (i.e. IRR) for the asset. CHART SEVEN highlights the differences between the approaches and how one generates a market appropriate price relative to a stabilized value.

As compared to the Cap on Market approach, the market appropriate analysis arrives at a significantly lower value -- a 26% discount versus a stabilized value. This discount creates a more attractive cash flow yield for the investor and provides balance between the cash flow and reversion components of the value, reflecting the risk inherent in the Long and Low scenario. Misalignment of these components, or an imbalance between cash flow and reversion, can lead to a material misrepresentation of value, if applied broadly.

A paired sales comparison has been provided within the appendix to further demonstrate the theory presented that is reasonably corroborated by actual sales activity.

[Acquired by the same buyer, within one week of each other, in the same market \(four miles apart\), these two transactions demonstrate the impact on value that the negative leasehold has and why blind application of a Cap on Market clearly does not reflect market behavior.](#) The buyer secured a significant discount on sale 2 vs. sale 1 (\$170/sf vs \$336/sf). The driver for this discount? The approximate 70% below market rent, combined with the 10+ years WALT, creates a \$125/sf negative leasehold. Furthermore, the Cap on Market from sale 1 of 5.2% is contrasted against that of sale 2 at over 10%, showing how market participants are accounting for “the details” of each transaction and adjusting the price accordingly. Clearly, in this real-world example, a valuer applying the Cap on Market from sale 1 to value sale 2 would end up very materially off from the true value/price. Once again, the details matter. By acquiring at \$170/sf the purchaser was able to secure the asset at a basis that more than compensated for the \$125/sf negative leasehold.

CHART SIX

Negative Leasehold Analysis - Subject							
Year	1	2	3	4	5	6	7
Market Rent	\$1,400,000	\$1,442,000	\$1,485,260	\$1,529,818	\$1,575,712	\$1,622,984	\$1,671,673
Actual Rent	\$560,000	\$576,800	\$594,104	\$611,927	\$630,285	\$649,193	\$668,669
Rent Loss	\$840,000	\$865,200	\$891,156	\$917,891	\$945,427	\$973,790	\$1,003,004
Safe Rate	4.00%						
NPV	-\$6,349,003						
Negative Carry	-\$63.00						

CHART SEVEN

	The Comp	Subject (Incorrect)	Subject (Correct)
Sale Price (At Market)	\$243	\$243	\$243
Less: Negative Leasehold	-\$16	-\$16	-\$63
Sale Price (At Contract)	\$227	\$227	\$180
Cap on Market	6.17%	6.17%	7.78%
Implied Year 1	2.58%	2.47%	3.11%
% Below Market	-6.6%	-6.6%	-25.9%

Conclusion

As more transaction data has become available over the last year, industry participants are applying various methodologies to assess the reasonableness of a valuation. However, when taking this approach, it is critical to obtain all of the underlying facts to ensure the data points are truly comparable. As demonstrated through both the hypothetical analysis and real world example presented herein, **focusing or relying too heavily on simplistic statistics like Cap on Market can have a distortive effect on values and lead market participants to question the validity of the process.** Investors have clearly demonstrated through executed transactions how they are pricing risk in the current environment. As demonstrated, a simple metric like Cap on Market, lacking details, is dangerous to the valuation process given the potential for severity of error.



It is critical to obtain all of the underlying facts to ensure the data points are truly comparable. Relying too heavily on simplistic statistics like Cap on Market can have a distorting effect on values and lead market participants to question the validity of the process.

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Appendix

Glossary of Terms

Capitalization Rate (Cap Rate): NOI divided by Value (or price).
 $10,000 / 2,000,000 = 5.0\%$

Implied Cap Rate: The cap rate derived from using the year 1 pro forma NOI.

Year 1 Cap Rate: Same as Implied Cap Rate.

Cap on Market: Cap rate derived by using the market rent (assumes NNN lease terms) for the property divided by the value or price.

Stabilized Cap Rate: Cap rate using contract rents when the asset's NOI reaches stabilization (often upon lease rollover), either in regard physical or economic occupancy. Can be current or future, see mark to market.

Mark to Market Cap Rate: Cap rate utilizing future NOI upon achieving economic stabilization after a period of below market rents.

Weighted Average Lease Term (WALT): Average of the remaining contractual lease terms. Can include options when rent is fixed and materially below market. Weighting is most commonly based on square footage.

Contract Rent: Stated rents per the in-place lease agreement(s).

Market Rent: Estimate of achievable rent for the subject if available at market terms.

Rent Loss: Differential between actual (contract rent) and potential (market rent) for the subject.

Negative Carry or Negative Leasehold: Cumulative Rent Loss discounted back at an appropriate rate.

Negative Leasehold (Actual Sales)

Comparable Sales Summary (WALT)		
	Sale #1	Sale #2
Date of Sale:	Jul-23	Jul-23
City, State:	Perris, CA	Perris, CA
Net Rentable Area:	333,572	147,354
Year Built:	2021	2017
Number of Buildings:	1	1
Economic Class:	A	A
Dock Doors:	44	26
Clear Height:	36'	32'
Site Area (SF)	731,808	357,628
Land-to-Building Ratio:	2.19	2.43
Property Rights:	Leased Fee	Leased Fee
Conditions of Sale:	Arm's Length	Arm's Length
Financing Terms:	Cash	Cash
Occupancy at Sale:	100%	100%
Sale Price	\$112,250,000	\$25,100,000
Sale Price Per SF	\$336.51	\$170.34
NOI Per SF	\$16.83	\$5.28
NOI/SF	5.00%	3.10%
Market Rent/SF	\$17.40	\$17.40
Cap on Market	5.17%	10.21%
WALT	6.7 Years	10.4 Years
Negative Leasehold PER SF	-\$4	-\$125



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