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# Is commercial real estate overpriced?

Stijn VAN NIEUWERBURGH

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# Is commercial real estate overpriced?

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*Valuations are sky-high but realised cashflow growth is sluggish. Much of the dichotomy could be attributed to the increased diversity of the commercial real estate ecosystem*

Those in the commercial real estate (CRE) business often put 'cap rate', or capitalisation rate, at the core of what they do. The metric is usually expressed as the ratio of net operating income (NOI) of a property relative to its current market value. Essentially, it measures the returns on an investment in a CRE asset.

Within the context of real estate investment trusts (REITs), the price-dividend (PD) ratio takes centre stage. Essentially a way to value a REIT stock, PD ratios in the U.S. market were about 10-15 times before the year 2000; in other words, REITs were trading around multiples of 10-15 times annual dividends.

After 2000, REITs were trading at 25 to 30 times annual dividends.

"Since the year 2000, with the exception of the 2008 Great Financial Crisis, we see that the market has been pricing much higher average cashflow or NOI growth expectations, something like 10-20 percent per year," notes **Stijn Van Nieuwerburgh**, Earle W. Kazis & Benjamin Schore Professor of Real Estate at Columbia University's Graduate School of Business.

"During the COVID crisis, as the market sold off in March 2020, cashflow growth expectations declined to about 10 percent from about 17 percent, but it quickly rose back towards the end of 2020 to something like 16.8 percent in December."

## WHY THE DICHOTOMY?

Speaking at the recent Mapletree Annual Lecture titled "*The Commercial Real Estate Eco-System*", Prof. Van Nieuwerburgh pointed out that, up to the year 2000, annual cashflow growth or NOI expectations in the U.S. REITs market were between zero to five percent per year, which were largely in line with realised cashflow growth.

Now, the market expects much higher cashflow growth but the realised figures were -16.5 percent in Q4 2020. In other words, U.S. REITs were pulling in 16.5 percent less than they did the previous year. Why the drastic disparity between reality and expectations?

"The market seems to be pricing in very high cashflow growth expectations that are unreasonably optimistic," observes Prof. Van Nieuwerburgh. "If you believe that, then what you're saying is the REIT market and maybe the broader commercial real estate market is due for a correction.

"There are other alternative explanations. One of them is that the REIT market is correct but it is disconnected from the broader commercial real estate market. A lot of real estate practitioners

like this explanation, which says investors treat the stock market like a casino and don't understand real estate."

While acknowledging the plausibility of these explanations, Prof. Van Nieuwerburgh proposes what he calls the Investor Composition Hypothesis. He elaborates:

> *"The ecosystem of commercial real estate investing has become much more diverse. I'm think of the large influx of large institutional investors such as sovereign wealth funds, pension funds, and university endowments that didn't used to invest in real estate.*
>
> *"But as bond yields started to fall there was this great rotation out of safe assets under the premise that interest rates only had one way to go, which was up, and when that happens bond prices fall, in which case that's not a good place to be. A lot of these types of investors rotated to commercial real estate under the idea that commercial real estate was bond-like – it was a safe store of value except, hopefully, it wouldn't suffer the same fate as bonds.*
>
> *"In addition, there's been a lot of cross-border investment in commercial real estate. Globalisation was happening in the equities market in the 70s and 80s, it's happening in the last 20 years in the commercial real estate markets. I think there is a reasonable possibility that the change in investor composition [could explain] who was the marginal agent that was pricing the commercial real estate assets [differently]."*

## SUPERSTAR CITIES, SUPERSTAR PRICE TAGS

To illustrate his point, Prof. Van Nieuwerburgh presented data on cross-border direct acquisitions in U.S. CRE since 2007, which went from nearly zero during the Great Financial Crisis to some US$100 billion in 2016, fuelled in large part by Chinese investors. Most of the investments were in office buildings located in gateway or 'superstar' cities such as Manhattan, Boston, and Washington, D.C.

By studying the 217,700 transactions of over US$5 million for office, industrial, and apartments space from 2001 to 2020, he classified the CRE buyers and sellers into eight categories:

- Foreign
- REIT e.g. Prologis
- REPE (Real Estate Private Equity) e.g. Blackstone
- Institutional
- Local developer/owner/operator
- National developer/owner/operator
- User e.g. firms that own the building they operate out of
- Individual

Using what he terms the Demand-Based Asset Pricing Framework, Prof. Van Nieuwerburgh worked out the different investors' beliefs about expected returns and the risks involved, and the resulting estimated demand elasticities. Foreign investors, it turned out, were the least price

sensitive. “When the Chinese investors want to buy that Manhattan office building, they will pay top dollar,” Prof. Van Nieuwerburgh notes.

Additionally, foreign investors value CRE assets in superstar cities more, which are reflected in the purchase prices. Prof. Van Nieuwerburgh: “From 2005 to 2020, foreigners absorbed 30 million square feet of office space in Manhattan. What would have happened to prices of Manhattan offices if those 30 million square feet of additional office space had been absorbed by the other types of investors?

“The short answer: prices would have increased by eight percentage points less than they actually did. In other words. About eight percentage points of the rise in Manhattan office prices is attributable directly to this surge of foreign investment.”

He adds: “With this framework you can do a lot of things. You can ask, ‘If the foreigners didn’t buy this much office space in Manhattan, they might have bought office space elsewhere; how would that affect the office market in San Francisco, Seattle, Singapore?’ You could ask, ‘How does that spill over to other sectors such as apartments, retail, and industrial real estate?’

“You could study all these substitution patterns between both the geographic substitution patterns across sectors, and you can do this granularly. You can literally ask, ‘What if Blackstone didn’t buy this one office building in San Francisco? How does it affect the price of this other building in Seattle?’”

*Stijn Van Nieuwerburgh was the keynote speaker at the Mapletree Annual Lecture (Webinar) that was held on 31 March 2021.*

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