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A Matter of Definition

It didn't take long for me to realize that the way things are learned in the classroom and how they are actually done in the real world can be dramatically different.

As a 'wet behind the ears' financial analyst in 1990, my then boss would give me financial underwriting models that he had marked up with handwritten notes. And these models would invariably have a few numbers denoted with the letters "PFA." This drove me crazy, as I had no idea what it meant but, as a freshly minted MBA, I was too embarrassed to ask. For weeks, I tried to figure it out, searching through all of my textbooks, reviewing all of my notes, even calling a couple of my former professors. With no answers and nowhere else to turn, I finally broke down and asked. Pencil and pad ready, I waited for a long and technical answer. And his response? "Plucked from air." This month, we are going to discuss some alternatives to the fabled "PFA," specifically as it relates to selecting a discount rate also known as IRR.

Before we get started, a quick discussion on the difference between a

discount rate and a CAP rate is in order. As stated in past articles, IRR and CAP rate are both investment measures but do not measure the same thing. IRR considers the performance of an investment over a period of time and includes a present value, a series of regularly occurring cash flows and a future value. On the other hand, a CAP rate considers the performance at a specific point in time and only includes income and price. Although a couple of the principles discussed below could be applied to a CAP rate, the focus of this article is on determining a discount rate or IRR.

The first approach to selecting a discount rate is called the build-up method. This method starts with a true risk-free rate as its base. The risk-free rate is the rate that an investor would require if there were no inflation and no risk – i.e., a pure return that ignores all outside fac-

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tors and influences. This base is then increased by both expected inflation and a risk premium. The expected inflation offsets any erosion of the base rate due to inflationary increases over the anticipated holding period. The risk premium allows the investor to recognize the fact that real estate carries definite risks – risks associated with the specific property, its tenancy, the local market, the broader capital markets, etc. The primary advantage of the build-up method is that breaks IRR down into three distinctive components. The primary disadvantage is that there is a fair bit of subjectivity involved, as estimates need to be inferred for both inflation and risk.

The next approach is to base the discount rate on an alternative investment. The most common is the 10-year Treasury bond, as this index already has inflationary risks built into its rate. An investor would then add a risk premium to account for market, tenant and property risk. Alternatively, if a single tenant occupies the property and the tenant has debt that is publicly traded, the debt's corresponding face rate can be used as the base. This will incorporate not only inflationary risks but also risks associated with the financial footing of the tenant. The investor will still need to adjust for market and property risk. The advantage to using an alternative investment is that it eliminates the guesswork associated with estimating inflation (as well as the risk associated with the tenancy, if using the tenant's bond yield for a single-tenant property). The disadvantage is that, although lessened, there is still some subjectivity involved when estimating the risk component.

A third approach is to base the IRR on industry surveys and/or market experience. Some of the more common sources include Integra Realty Resources (irr.com), Green Street Advisors (greenstreetadvisors.com), Real Estate Research Corporation (research.rrc.com) and PriceWaterhouseCoopers (pwc.com). All of these produce regular surveys, some available for free, some for purchase and some only for clients. These surveys detail current discount rates by

Daus, You Know?

DUKIN' IT OUT Last month, Duke Realty sold a portfolio of suburban office assets in several Midwest and Southeast markets, including Chicago, Atlanta and Dallas. This follows its 2007 shedding of a portfolio of office properties in Cleveland's eastern suburbs. The most recent sale averaged \$107 per square foot while the Cleveland sale four years earlier averaged \$155 per square foot. –AP


product type and geographic region. Alternatively, if an investor owns properties that are similar in style, type and location, the IRR generated by the portfolio can be used as a benchmark. The advantage of using this method is that the information is readily available and objective in nature. The disadvantage is that it is general to a market segment and not specific to an investor and/or a property.

A fourth approach is to use a discount rate that is implied by the CAP rate. As stated earlier in this article, a CAP rate is determined by income and price. IRR introduces a time element or holding period and the intervening cash flows that occur during this holding period. So one way of defining IRR is that it equals the CAP rate plus the expected growth


in income and value over the holding period. A quick example – suppose that a property can be purchased at a CAP rate of 9%. And further suppose that over the hold period, the expected increase in income and property value is expected to be 3% annually. In this instance, the expectation for the IRR would be 12% (9% CAP rate plus 3% growth in income and value). The advantage of this method is that it uses an objective base from which to start, as the CAP rate is simply a by-product of income and price. The disadvantage is that the expected growth can be subjective in nature.

Determining target IRRs is an often ignored but critical part of an investor's strategy. By having some concrete methodology in developing these targets, the end results stand a much better chance of being A-OK rather than PFA. **P**

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