

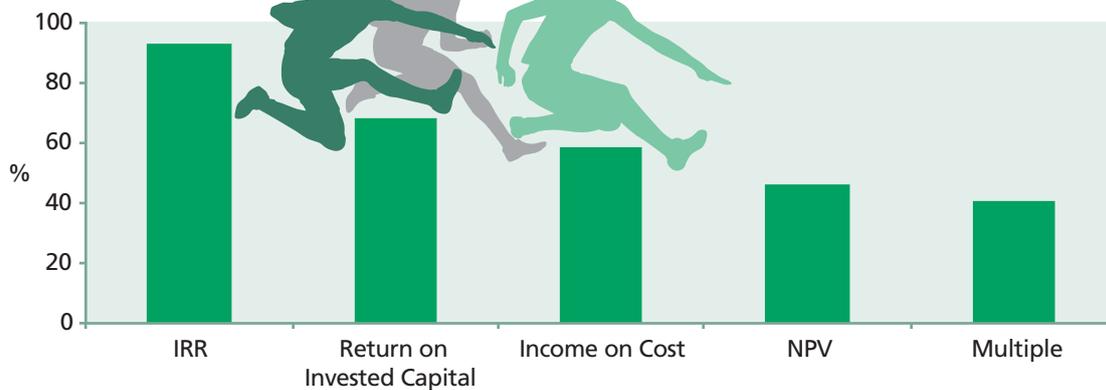
AN INVESTIGATION OF HURDLE RATES IN THE REAL ESTATE INVESTMENT PROCESS

How do real estate investors make investment decisions? This research examines the extent to which hurdle rates are used and the key drivers in determining them.

Most Frequently Used Decision Tools

"simulation approach to assess parts of the risk premium"

"fund level minimum return plus risk premium"



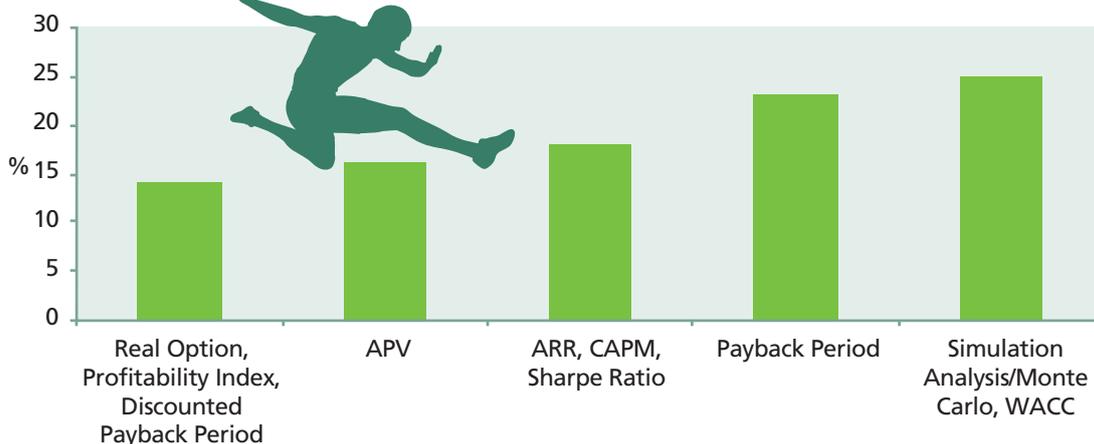
"real bond yield plus expected inflation and risk premium"

"WACC plus risk premium"

"for ungeared: IPF consensus (five-year) plus 1% outperformance objective"

"fixed plus cost of capital, depending on the mandates"

Least Frequent





Key Facts

- Hurdle rates are widely used in investment decision-making although market practice varies widely on how these are determined.
- Key differences are driven by the type of organisation, its size, and the type or style of investment.
- Target rates of return and performance targets define hurdle rates for organisations attracting capital for specific investment strategies. These, in turn, are determined by the demands of clients, actions of competitors and the weight of capital relative to the investment vehicles available in the market.
- Where not dictated by clients, hurdle rates are constructed via a 'risk free rate plus risk premium' basis of valuation.
- It is standard practice to adjust hurdle rates at the project level, with market, sector and cycle adjustments augmented by property-specific premia.
- The impact on market risk at the portfolio level rarely appears in any deal decision.
- DCF is frequently used and IRR dominates NPV as a decision tool. Non-cashflow metrics (particularly multiple and profit on cost) are similarly favoured.
- Few organisations employ technically complex quantitative models in the investment decision process and there is little apparent back-testing of decision rules.
- It is common for the manager presenting a deal for approval to amend and adjust model inputs, fine-tuning hurdle rates or required yields at the asset level.
- Individual investment decisions seem to take limited account of wider portfolio considerations.
- Few examples were found where the final investment decision was explicitly based on the risk-return impact on the portfolio as opposed to the risk-return and downside risk scenarios as applied to an individual deal or asset.
- Skills issues limit the use of more sophisticated techniques or more systematic approaches to testing assumptions and sensitivities.
- More rigorous quantitative approaches are constrained by data inadequacies and resistance from more traditionally-minded senior management.

Click here to download the full report from the IPF website

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