

Water Market Insider



Q2 2019

Premium for Buying Water

Cap Rates for Water Rights

What is a Cap Rate?

Capitalization rates, or “cap rates”, are a commonly used metric in evaluating real asset investments, such as farmland and real estate. Investors pay close attention to cap rates to understand the potential for annual revenue relative to the investment cost. However, these more conventional real asset investments benefit from established markets with active leasing and sales that create a transparent and robust cap rate.

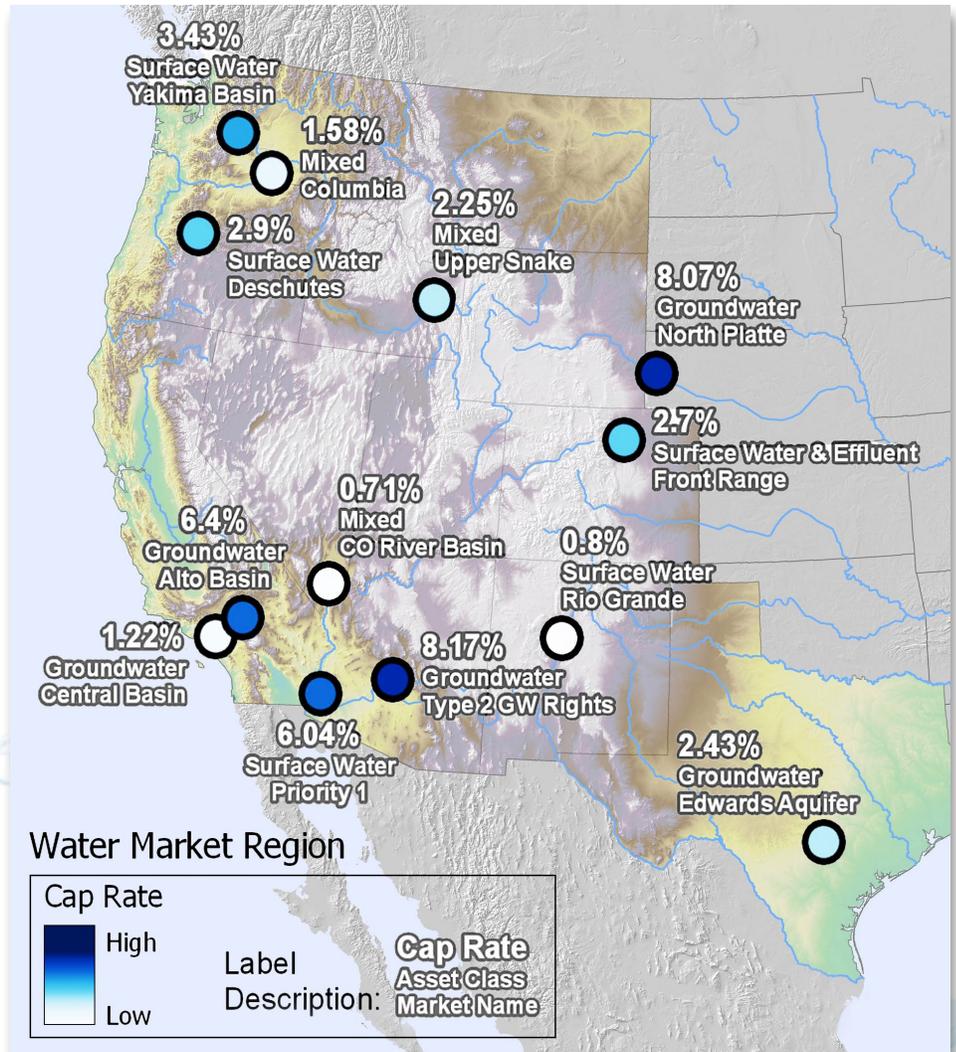
Cap rates for water rights are more challenging. Trading activity in regional markets is still relatively new and is usually dominated by leases or sales, but rarely both. More recent trends show that both leasing and permanent sales are becoming more common in at least 13 markets across the West – allowing for the calculation of a cap rate for water rights by comparing lease rates to sale prices.

Cap Rates for Water Markets

Cap rates were calculated for 13 unique and geographically-isolated water right markets in the Western U.S. as mapped in Figure 1. These regional markets were chosen based on having a sufficient number of sales and leases over the recent 3-year period 2016-2018 in a common market area.

Cap rates varied across the selected markets, ranging from less than 1% to over 8%. Local market conditions drive this variability. In many Western water markets,

Figure 1: Map of Cap Rates for Water Rights



cap rates are found to be relatively low because market demand is dominated by the municipal water utility sector that places a premium on permanently acquiring water right assets and heavily discounts water leases. It is common to see municipalities buy water rights in advance of projected need and then lease the water back to a local market at a discount; as

a way of banking water supplies. In some areas, this model is changing as municipal water providers are incorporating leased water supplies into their management strategies. Cap rates increase in markets where we find common market participants, diversity in buyers and sellers, and consistent trading.

Figure 2: Multi-Family Real Estate

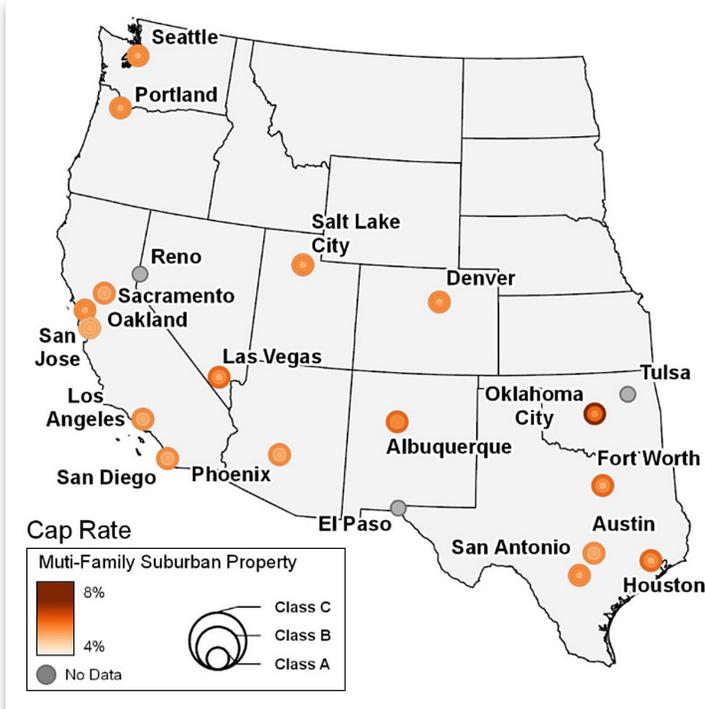
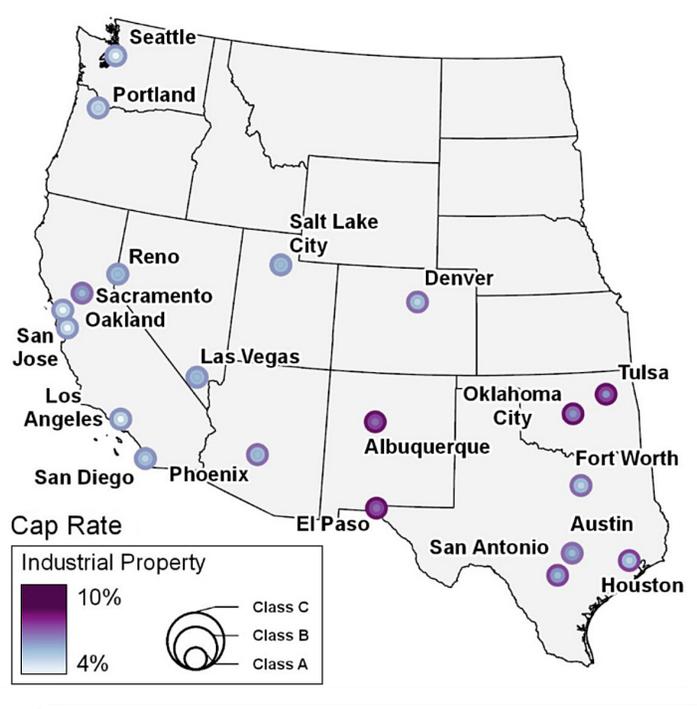


Figure 3: Industrial Real Estate



Regulatory conditions can also play an important role in shaping cap rates, by influencing the market demand for permanent sale and temporary lease water supplies. Higher cap rates are found in local markets where we find regulatory or economic constraints on permanent acquisitions, and leases represent a viable option.

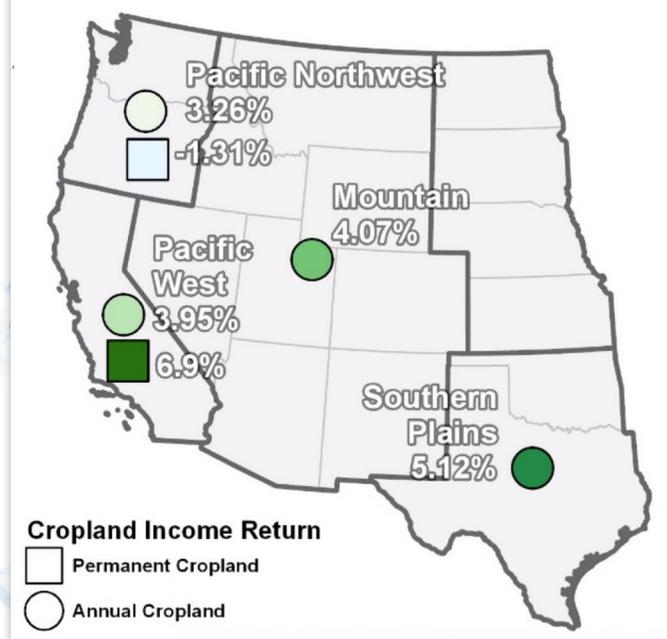
Data Sources:

Water Rights: Waterlitix, WestWater proprietary database of water right transactions

Multi-Family & Industrial Real Estate: CBRE North America Cap Rate Survey, 2nd half 2018

Cropland: NCREIF Farmland Property Index. Quarterly Report. April 25, 2019.

Figure 4: Cropland



Comparison with Conventional Real Asset Cap Rates

Cap rates for water rights are a relatively new development across Western US water markets. However, cap rates in regions with maturing markets are comparable with other real asset classes such as farmland and residential real estate. Farmland property cap rates calculated from farm income data recently reported by the National Council of Real Estate Investment Fiduciaries ranged between 3% to 7% across the Western states. Similarly, cap rates for multi-family and industrial properties reported by CBRE range from 4% to 10%

Summary

Cap rates for water will become a more common metric as water right trading continues to increase across the Western US. However, early stage cap rates for water are relatively low when compared to other more established real asset investments. At this time, this is largely driven by municipal and other high-value

buyers that have historically focused on permanent acquisition of water rights. Increasingly, we see high-value water users entering into multi-year lease agreements as the permanent sale market tightens. As in other conventional asset classes, cap rates for water will become an important metric in the decision to own or buy.