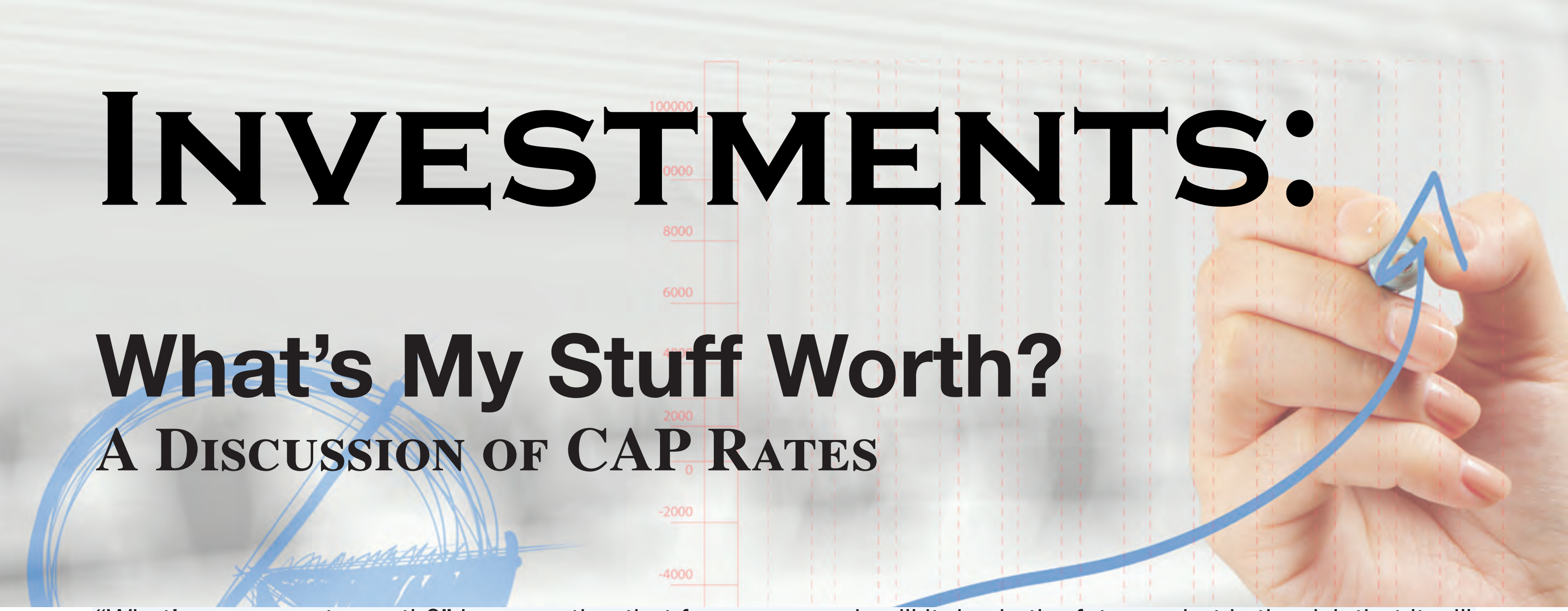

Investments:

What's My Stuff Worth?

A Discussion of CAP Rates

"What's my property worth?" is a question that frequently pops into the minds of real estate investors. How do I compare the 20 units that sold down the street to my 8 units here? One way to estimate a value for your property is by using a Capitalization Rate, or CAP Rate. We'll talk about the use of the CAP Rate measurement this month.

The Investment Real Estate Market

As I often emphasize, an investment property's value is entirely based on the cash flow it produces. Many investors think less about buying property, and more about buying cash flow. They look at the cash flow a building produces – how much is it now, how much will it rise in the future, what is the risk that it will stop? – and price the assets accordingly. As an experienced real estate buyer once told me, "Real estate is worth nothing to me – I buy cash flow. The only real estate worth anything is the last California State landmark where someone was hung." This colorful expression helped me remember this crucial point.

How are Investment Properties Valued?

An investment property's sale price can be estimated using a multiple of the cash flow it generates – the CAP Rate. A CAP Rate will tell you what a property will return if it is purchased for all cash, (not

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subject to a loan) without taking capital expenses into account. For example, a $1,000,000 apartment complex purchased at a CAP Rate of 5% will yield a net income (before taxes), of $50,000 annually – without taking into account loan payments or the $7,500 per year you are saving for the new roof. Without raising rents, if you sold the property at a 2.5% CAP Rate, you would receive $2 million. At a 10% CAP Rate, the price is $500,000. This shows what a large effect CAP Rates have on value and prices.

CAP Rates loosely follow interest rates in the marketplace. While commercial CAP Rates and the 10-year treasury rate are not directly correlated, they serve as a good basis for comparison. For example, if the 10-year treasury bond is paying 5%, an investor may be willing to pay a 6% CAP Rate for real estate. An investor expects real estate to appreciate (while the bond's value is deflated by inflation), so is willing to take an extra 1% of income, and this appreciation as compensation for additional risk.

As real estate must compete with other investment options for dollars, these CAP Rates will adjust. In the example above, if the 10-year treasury rate rose to, say 7.5%, the investor may not want to accept a 6% return and the risk that goes along with real estate when he can earn 7.5% risk-free. This CAP Rate this investor would pay may look more like 8%. Since interest rates seem likely to rise in the future – this could lead to upward pressure on CAP Rates (and downward pressure on value.)

In the past, we saw some amazingly low CAP Rates here in Orange County, particularly in apartment houses. Some apartment buildings locally were trading for CAP Rates as low as 3 or 4 percent; this means that owners were buying them with negative leverage – borrowing money at 6 or 7 percent to fund a property paying 3 or 4 means a lower return for the investor – perhaps even a zero return. Investors were paying these higher prices for expected appreciation. If CAP Rates are likely to rise in the future, however, this appreciation may be hard to come by. For instance; if an investor purchased a property at a 3% CAP Rate, and sold at a 6% CAP three years from now, he would lose 50% of his value. To keep the same value, his net income on the property would have to double. This would mean doubling rents, and hoping that expenses stayed the same. Although lower affordability for single family homes mean that the chances of apartment rents rising over the next several years is good, it is not likely they will double. Even if they did, that is a lot of work to just "stay even." A smarter alternative is to be a seller at 5% CAPs, and to buy in other markets at, perhaps 6-7% CAPs.

Using the CAP Rate

Now that you have a good understanding of what the CAP Rate measurement it, its importance, and some things that can influence it, let's talk about using it.

Let's say that, this year, those 20 units down the street from your property sold at a 6.0% CAP Rate, and that another 10-unit property on the block sold at a 6.2% CAP at about the same time. If your property is similar in condition and type (all 2 BD, 1 BA units, for example), than a good estimation of your CAP Rate falls in this range. We'll go on the conservative side and use 6.2%.

If your gross rents are $180,000 per year, and your expenses (Property taxes, maintenance, insurance, utilities, etc.) total $60,000 annually. This leaves you with a Net Operating Income (NOI) of $120,000. To estimate value, divide this number by your CAP Rate. The calculation will look something like: $120,000 / 0.062 = $1,935,483. This gives you an estimated value of just under $2 million.

Knowing what your properties are worth is an essential part of the real estate investment business. A savvy owner is always watching the market. When his value is above what he thinks the property is worth, he may consider selling to complete a tax-deferred 1031 exchange into property he feels is undervalued – in order to keep his portfolio value growing while he's earning income. If you have any questions, please call me at (877) 313-1868.

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