FINANCIAL ADVISORY

Investment Property Valuation – a Discussion of CAP Rates

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How can we compare two potential real estate investments with each other? We can do the math and compare the cost per square foot or, in the case of apartments, the cost per unit. We can also use measures such as the Gross Rent Multiplier, which measures price compared to gross rents received, or a CAP Rate, which measures price based on Net Operating Income. (NOI.)

This month, we'll discuss how to use CAP Rates when evaluating potential property purchases.

WHAT IS A CAP RATE?

A CAP Rate is used to estimate the value of a property based on it's Net income. One advantage of this measure over the Gross Rent Multiplier is that it accounts for the possibility that some properties will have higher expenses than others. In theory, if two properties have the same gross rent, the one with the lower expenses will be worth more since it provides the most Net income.

A CAP Rate is expressed as a percentage. If you were to buy a $3 million property with all-cash (no

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loan) at a 6% CAP Rate; your net operating income (NOI) would be $3,000,000 X .06 = $180,000.

WHAT IS NOI AND HOW DO I CALCULATE IT?

What if I want to estimate the value of my property using my Net Operating Income? First, you'll need to find what that number is. Your Net Operating Income is your gross rents less your operating expenses. Note that neither your loan payments (principal and interest) nor any capital costs (large expenses such as roof replacements, major renovations) are included in the NOI calculation.

If my building collected $225,000 of annual rent and had $45,000 of annual expenses, then that would give me an NOI of $225,000 - $45,000 + $180,000. But what if my loan payments are $180,000 annually? Remember – that isn't counted in the NOI calculation.

HOW DO I KNOW WHAT CAP RATE TO USE?

To get an idea of what CAP Rate to use; take a look at real estate listings in your area or ask a local investment broker for some input. If you are looking at real estate listings, remember to reference those listings with the later closing data to get an idea of the real prices that investors are paying. Remember – a seller can ask for whatever he wants in a listing.

If you see properties in your area generally selling for around a 4% CAP Rate, than this could be a good value to use for your estimation.

TO ESTIMATE VALUE, DIVIDE NOI BY CAP RATE

If you divide your $180,000 NOI by your 4% CAP Rate, you'll get an estimated value of $4,500,000. You can see that this is a much higher value estimation than the 6% CAP Rate above yielded. This is why estimating a CAP Rate that is accurate for your property and your location is so important.

The term "CAP Rate" is one of several real estate terms that is thrown around often, but is rarely defined so that investors can understand it's significance. My goal for this article was to introduce investors to what the CAP Rate metric means and how it can be used. Now that you understand this measure, you can use it to evaluate potential acquisitions and perhaps make better buying choices. If you have any questions, my office number is (877) 313-1868.

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