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Understanding Cap Rates

Capitalization Rates are used by appraisers, lenders and investors as a tool in evaluating income producing real estate. To over-simplify a little bit, the Cap Rate is an expression of the return you would get if you paid cash for a property. No financing is taken into effect in this calculation.

Capitalization formula: I = Net Operating Income, R = Rate, V = Value

Income = Rate X Value (I=R X V)

Value = Income/Rate (V= I/R)

Rate = Income/Value (R = I/V)

Net Operating Income (NOI) or “ I “ in the formulas above, is derived by taking

- ◆ Gross Income (monthly rental income x 12)
- ◆ Less vacancy (depends on the location and the state of the market) and credit losses (like bounced checks)
- ◆ Plus other income (like late fees)
- ◆ Less Operating Expenses (both fixed and variable including property management fees and capital reserve for future capital expenditures)

Sample Operating Statement:

A 250 unit apartment building complex with rent schedule of \$450 per month per unit is selling for **11,100,000 (V for value)**

Potential gross income: 250 x \$450 x 12 months =	\$1,350,000
Less vacancy and credit losses (6%)	-81,000
Plus other income	+25,000
Gross effective income	\$1,294,000

Less expenses

Fixed expenses:

Property insurance	\$24,500	
Property taxes	\$95,300	
Licenses & permits	\$ 1,200	\$ 121,000

Operating expenses:

Maintenance	106,000	
Utilities	103,200	
Supplies	16,000	
Advertising	7,500	
Legal & Accounting	15,000	
Wages & Salaries	90,000	
Property Management	64,700	\$ 402,000

Replacement Reserve:	\$25,000	\$ 25,000
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Total Expenses (\$548,000)

Net Operating Income (I for Income) \$745,600

For the above Operating Statement the Income and Value has been given. Now find the rate.

R = Income/Value
Rate = \$745,600/\$11,100,000
R = 6.7 %

Once you have come up with a cap rate, the next step is to determine whether that cap rate fits with your overall buying strategy, and whether you can obtain financing for your purchase. If you are purchasing a commercial property (5 units and up is generally considered to be commercial), the local portfolio lenders can tell you what cap rate they want to see before considering financing your deal. In general,

High Risk = High Capitalization Rate = Low Value
Low Risk = Low Capitalization Rate = High Value

Cap Rates are just **ONE** of several tools used in evaluating a purchase. And market cap rates can also be used to set a selling price. Once you have an NOI, you can apply the current market cap rate to determine the value. Cap rates are set by market conditions – the lower the cap rate, the higher the price.

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New Hampshire Real Estate Investors Assn

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