Capitalization Rate Information

Excerpted from information prepared by Advantage Software, LLC.

The Capitalization Rate or Cap Rate is a ratio used to estimate the value of income producing properties. Put simply, the cap rate is the net operating income divided by the sales price or value of a property expressed as a percentage.

Cap rate (%) = Net Operating Income (NOI)/market value

OR

Estimated market value = NOI/cap rate

Example:

A property has a NOI of $120,000 and cap rates in the area for this type of property average about 10%.
Estimated market value = $120,000/.10 = $1,200,000

Investors, lenders and appraisers use the cap rate to estimate the purchase price for different types of income producing properties. A market cap rate is determined by evaluating the financial data of similar properties which have recently sold in a specific market. The Cap Rate calculation incorporates a property's selling price, gross rents, non rental income, vacancy amount and operating expenses thus providing a more reliable estimate of value.

If we have a seller and an interested buyer for particular piece of income property, the seller is trying to get the highest price for the property or sell at the lowest cap rate possible. The buyer is trying to purchase the property at the lowest price possible which translates into a higher cap rate. The lower the selling price the higher the cap rate. The higher the selling price, the lower the cap rate. In summary, from an investor's or buyer's perspective, the higher the cap rate, the better.

Investors expect a larger return when investing in high risk income properties. The Cap rate may vary in different areas of a city for many reasons such as desirability of location, level of crime and general condition of an area. You would expect lower capitalization rates in newer or more desirable areas of a city and higher cap rates in less desirable areas to compensate for the added risk. In a real estate market where net operating incomes are increasing and cap rates are declining over time for a given type of investment property such as office buildings, values will be generally increasing. If net operating incomes are decreasing and capitalization rates are increasing over time in a given market place, property values will be declining.

If you would like to find out what the cap rate is for a particular type of property in a given market place, check with an appraiser or lender in that area. Be aware that the frequency of sales for commercial income properties in a given market place may be low and reliable capitalization rate data may not be available. If you are able to obtain a market cap rate from an appraiser or lender for the type of property you are evaluating, check to see if the cap rate value was determined with recent sales of comparable properties or if it was constructed. When adequate financial data is unavailable, appraisers may construct a cap rate through analysis of its component parts thus reducing the credibility of the results. Cap rates which are determined by evaluating the recent actions of buyers and sellers in a particular market place will produce the best market value estimate for a property.

If you are able to obtain a market cap rate, you can then use this information to estimate what similar income properties should sell for. This will help you to gauge whether or not the asking price for a particular piece of property is over or under priced.

Net operating income is determined by subtracting vacancy amount and operating expenses from a property's gross income. Operating expenses include the following items: advertising, insurance, maintenance, property taxes, property management, repairs, supplies, utilities, etc. Operating expenses do not include the following items: improvements such as a new roof, personal property such as a lawn mower, mortgage payments, income and capital gains taxes, loan origination fees, etc.