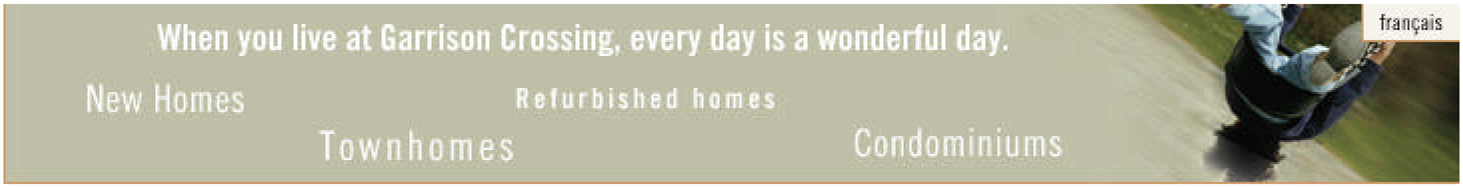
Search

Your Ad Here



PRODUCTS LISTINGS EXPERTS FINANCING DIRECTORY EVENTS HOME REAG THE JUROCK INSIDER

home → commercial → commercial tips

What's a cap rate anyhow?

Search

by *Ozzie Jurock*

Ads by Google

Commercial RE Investments
Triple Net Lease, Tenant in Common, 1031 Exchanges, REITs, Funds, LLC.
www.1031ExchangeOptions.com

Commercial Real Estate
Leading experts in lending & equity investments. 1.888.433.4778 x1212
www.gerealestate.com

Commercial Broker License
Get Your Real Estate Broker License Quick & Easy. DRE Approved Courses!
www.RealEstateLicense.com

Find Commercial Property
Search for Commercial Property For Sale or Lease. Nationwide Listings.
www.LoopNet.com

AZ Investment Property
Hassle-free cash flow, 10%+ annual returns. Invest now. Phoenix, AZ
www.reddoorgroupinc.com

One of the most difficult and perplexing problems for realtors and investors is finding current Gross and Net Income Multipliers and Cap Rates. Determining the value of an income property generally involves establishing either the Gross or Net Income Multipliers, or the Cap Rate according to comparables.

There are a number of difficulties:

- **Finding comparables and market information**
  Information relating to a sale of a commercial property is often confidential and difficult to obtain. While the sale price can usually be determined, the Income and Expense Statement, Net Operating Income etc. is often not available, making it difficult to calculate the financial measures.

- **Discovering the underlying motives** behind the purchase and adjustments that may have been made by the purchasers.
  The financial measures are simply ratios that have been derived from the purchase price and the financial figures. They reflect the attitudes and the results of the negotiations between the buyer and the seller, economic conditions etc. In some instances, the purchaser may be strongly motivated by income tax considerations, other times; the motivation may be to move money into another country by an overseas investor. Often, purchasers make adjustments to compensate for particular circumstances relating to the particular property. As an example, if a purchaser estimates that there is $250,000 to be spent immediately on major repairs, then the $250,000 will be deducted from the purchase price. Additionally, if the building has an assumable first mortgage, which is well below the current rate, the purchaser may pay more for the property than for a comparable property, which requires financing at the current market rate.

  If the analyst is unaware of special buying or selling motives, or that the purchaser has made adjustments to the price because of special circumstances, such as the requirement for major repairs, or because of favorable or unfavorable existing financing, then the calculation of the financial measures will be incorrect. This will lead to erroneous and misleading estimates of the market value for the subject property. **On the surface, the calculation of cap rates seems to be a relatively simple process. However, it is fraught with difficulty**

and uncertainty, and requires a lot of digging for information, questioning, and being alert to special circumstances, which may distort the answers.

- **The number of comparable is often limited**.
  Finding comparables for a residential property is relatively easy. There are usually plenty of recent sales and an abundance of comparables or near comparables. In contrast, there are relatively few commercial sales, and finding comparables is very difficult because there may not be many comparables available, and obtaining the information such as the income and expenses may be difficult.

  As an example, finding comparables for a 5,000 Sq Foot, 10-year-old suburban retail complex, which has five tenants with different lease renewal dates and is situated in a poor location for retailers would be very difficult. There is unlikely to be a direct comparable available which has sold "recently." The approach in this situation is try to find some sales that are at least close to this situation and then make adjustments to try and take into account the specific differences such as the timing of the lease renewals, locational factors, age, financing etc.

The Net Operating Income is probably the most widely used indicator of the building's financial performance, and is frequently used in determining the value of the property. The Net Operating Income is the cash remaining after deducting the Operating Expenses from the Effective Gross Income (EGI). There are several items, which often appear on financial statements, which must be deleted before calculating the Net Operating Income (NOI).

1. Debt Service, i.e., principal and interest payments are ignored because the Net Operating Income reflects the earning capacity of the property exclusive of financing.

2. Depreciation allowances or any other purely bookkeeping or Income Tax deductions are ignored.

3. Capital Expenditures which provides long term benefits such as replacing appliances, painting of the building etc. are omitted.

The Capitalization Rate:
The Cap Rate is calculated as follows:
Cap Rate = (Net Operating Income / Market Value) x 100
Cap Rate = (NOI / MV) x 100

Example:
Net Operating Income (NOI): $239,430
Market Value (MV): $3,420,000

Cap Rate = (239,430 / $3,420,000) x 100
Cap Rate = 7%

The Cap Rate of 7% represents the annual return before mortgage payments and income taxes on the total investment of $3,420,000.

Alternatively, if the Cap Rate can be established from comparables, we can determine the likely selling price of a property. For example, if the cap rate is 7.5 % based on comparables, and the Net Operating Income (NOI) for the building is $105,000 , the potential selling price can be calculated as follows:

MV = (NOI / Cap Rate) x 100
MV = (105,000 / 7.5) x 100
MV = $ 1,400,000

The Net Income Multiplier (NIM)

The Net Income Multiplier (NIM) is the inverse of the Cap Rate

NIM = 100 / Cap Rate
or Cap Rate = 100 / NIM

As an example, if the NIM is 11, the Cap Rate is:

Cap Rate = 100 / NIM
Cap Rate = 100 / 11
Cap Rate = 9.09%

Both the Cap Rate and its counterpart the Net Income Multiplier are used in the real estate industry to estimate the market value of a property. However, in recent times, the Cap Rate has become the more popular financial measure. Regardless of which measure is used; they both produce the same estimate of market value.

The Net Income Multiplier is expressed as follows:
Net Income Multiplier (NIM) = Market Value / Net Operating Income
i.e. NIM = MV / NOI
Example:
Net Operating Income: $239,430
Market Value (MV): $3,420,000
NIM = MV / NOI
NIM = 3,420,000 / 239,430
= 14.28

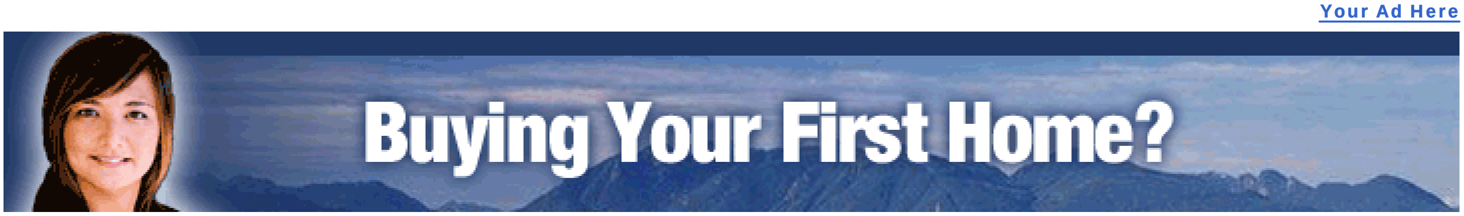
Alternatively, if the Net Income Multiplier can be established from comparables, we can determine the likely selling price of a property. For example, if the Net Income Multiplier is 7.0 based on several comparables, and the Net Operating Income for the building is $180,000 , the potential selling price can be calculated as follows:
MV = NOI x NIM
MV = $180,000 x 7
MV = $1,260,000.

jurock.com

About the Writer:
Ozzie Jurock is the president of Jurock Publishing Ltd., Editor of Real Estate Insider Publication and Author of Forget About Location, Location, Location

- **More Commercial Real Estate Tips >>**

Your Ad Here



Privacy | Security | Site Map | Advertising | FAQ | Masthead | Contact Us
REAG: Canadian Real Estate Investment Club
Reproduction of material from any Jurock.com pages without written permission is strictly prohibited.
©2007 Jurock Publishing Ltd. All rights reserved.