As appeared in...

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COLORADO REAL ESTATE JOURNAL

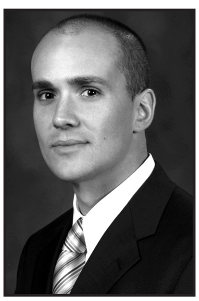
THE COMMUNICATION CHANNEL OF THE COMMERCIAL REAL ESTATE COMMUNITY

AUGUST 6, 2014 – AUGUST 19, 2014

Cap rates: Widely used, yet misused in the marketplace

Management	Risk Profile	Net Operating Income	Capitalization Rate (OAR)	Indicated Value
$10,000	Lower	$125,000	7.50%	$1,666,667
$0	Higher	$135,000	8.10%	$1,666,667

Ask any real estate professional what a capitalization rate is and you are likely to get a variety of answers. Every trade publication, published article, market participant and third-party report relating to real estate quotes cap rates for various markets. If cap rates are widely used and easily calculated, then why are they commonly misused in the marketplace? This article will briefly discuss what a cap rate is, an appropriate method to extract or calculate a cap rate, and why it is commonly misused in the marketplace.



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■ **Cap Rate Overview.** A cap rate in its simplest form is a return on your investment based on the principle of anticipation. Value is the present worth of future benefits. A cap rate attempts to quantify the risk profile of the future benefits. It is a rate that is calculated by using a noncomplex formula (R=I/V), where I is the net operating income and V is the value of the property. In more complex terms, a cap rate is a rate that measures a single period, unleveraged rate of return on a real estate investment.

■ **Cap Rate Components.** A cap rate is comprised of three components: net income, property value and the rate of return (cap rate). If two of the three variables are known, the unknown variable can be extracted through a simple calculation. Different types of cap rates exist: overall rate, terminal rate, equity rate, mortgage rate, building rate and land rate. The overall rate is the rate applied to both the land and building and is the most commonly used rate by real estate professionals.

■ **Sources.** A quick review of the various sources will uncover different rates for the same investment class of property and submarket. If a cap rate is easily calculated, then why is there disagreement between the various sources?

1. Misuse in the Marketplace. Disagreement on an appropriate cap rate can have an impact on the property being valued. Common reasons for variations in cap rates are attributed to the income stream and operating expenses used in the extraction of the rate. Failure to consider the likely future income of the property (year-one pro forma) does not follow the principle of anticipation. Extracting a cap rate from market data using historical income and applying it to the year one projection of the property being valued will result in an incorrect value opinion. The same income and expense projections used to extract a cap rate from the market should be used to value a property.

Many market participants do not include replacement reserves as an above-the-line (net income) expense when developing cash flow projections. Including replacement reserves will have an impact on the cap rate extracted from the sale transaction, not the value of the property. Neither method is incorrect as long as the same method is applied to the property being valued. If the sale comparable does not include replacement reserves in its pro forma projection, and the subject does include replacement reserves in its year-one projection, the market extracted cap rate must be adjusted downward to reflect a riskier income profile of the sale transaction when compared to the asset being valued.

2. Owner-Managed Properties. Another common misconception in the marketplace addresses third-party management fees. Having a third-party management company manage your asset may reduce the operational risk of the property and can result in a lower risk profile of the future income stream. A lower risk profile results in a lower cap rate. The accompanying table shows how excluding third-party management fees impact the year-one return.

Market analysis reveals that a 7.5 percent cap rate is appropriate if the property pro forma includes expenses for third-party management fees. Based on the projected NOI and market extracted cap rate, a value of nearly $1.67 million is indicated. If the same property does not include management fees in the pro forma projection, the value of the property is unchanged with the risk adjusted cap rate increasing to 8.1 percent.

3. Expense Comparison in Sale Comparables. Comparing the operating expenses used in a sale comparable to extract a cap rate is a good indicator if the cap rate is market driven. A comparison of the expenses from the comparables to industry standards used in the local market will allow the analyst to adjust the extracted cap rate accordingly and then apply the revised cap rate to the property being valued. If a data set of comparable sales indicates a wide range of cap rates, then it is likely that one or more of the sales are not based on market derived income and expenses.

■ **Conclusions.** There is no standard method for cap rate extraction, with various market participants applying different income and expenses projections when calculating the net operating income. However, a standard method for extracting a cap rate from market data is critical to properly value a property. Not all net operating incomes have the same risk profile. Regardless of the variables in the cap rate extraction, if applied consistently to the property being valued, a reliable estimate of value will result.▲