CRE "By the Numbers": Understanding Cap Rates

Over the last year, we've delved into top terminology, jargon, and concepts that every commercial real estate (CRE) professional needs to have top of mind.

Let's dive into another core skillset: CRE calculations and financial concepts, specifically, capitalization rate (cap rate).

Capitalization Rate

Previously, we discussed how cap rate, and the associated value Net Operating Income (NOI), are related to one another. In brief, the calculation is:

Cap Rate = NOI / Current market value of the asset

What does this calculation tell us? In the most direct sense, cap rate explains the rate of return an investor should expect to see. In other words, it shows how quickly they could expect a return on capital given the amount they paid (or are considering paying) for a property.

For example, if Property A has a NOI of $250,000, and the asking price is $2,000,000, the calculation becomes:

$250,000 / $2,000,000 = 0.125 or a 12.5% cap rate.

Meanwhile, Property B has an NOI of $120,000 and is asking $2,000,000, making the cap rate 6%.

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In this case, Property A seems like a far better investment on the surface of things because the rate of return is clearly much higher. What's also often true, however, is that the higher the cap rate, the higher the inherent risk. A property with a high cap rate could be in a poor location that lowers property value, may not have reliable tenants, or could a result of any number of other factors that represent a trade-off between long-term value and short-term cash flow.

The current rental price that's driving NOI might also be unsustainable and likely to drop off in the future. So there may be a stronger risk of the returns declining in the long run than with a "slow but steady" low cap rate investment.

Calculated Comparisons

What's important for investors, and CRE professionals, to bear in mind is that part of due diligence when looking at cap rates is to pay careful attention to the situation of similar properties in the market. Knowing what's likely to change in each market is also key.

Going back to Property B from the example above, a bit of research might turn up the fact that the current rents being charged are below market value, possibly due to poor management or because the building needs some basic improvements.

As it turns out, with some market appropriate rent increases, the property could generate $160,000 NOI, bringing the rate of return up to 8%.

Another possibility is that there's new development coming to the area that could boost the potential value of the property, making a low cap rate more worthwhile.

Multiple Metrics

As the above examples show, what constitutes a "good cap rate" is going to depend on the market, the fundamentals of that market, and the amount of risk an investor is prepared to tolerate. Also worth noting is that cap rates are just one of the metrics savvy investors should consider when calculating the value of a property.