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# CRE Terms: Defining Finance

In this article, we will be digging into important and often misunderstood financial terminology.

## Cap Rate

The one financial term you'll arguably hear most often is 'capitalization rate', or 'cap rate'. The Corporate Finance Institute defines this as the "rate of return on a property" or a "return metric that is used to determine the potential return on investment or payback of capital". This is calculated by dividing the net operating income by the current market value, as per the graphic below.

Net operating income (NOI) is net of all expenses including management fees and taxes. The NAIOP Terms and Definitions document which we rely on for this series of blogs gives the following easy-to-digest example: "a property's capitalization rate (cap rate) is 10 percent if it is purchased for $10 million and produces $1 million in NOI during one year". They go on to add that the cap rate is often used as a means of comparing potential returns between similar investment properties, and typically for this, the NOI used is that which is generated in the first year of ownership.

$$\text{Capitalization Rate} = \frac{\text{Net operating income}}{\text{Current market value of asset}}$$

Image source: https://corporatefinanceinstitute.com/resources/knowledge/valuation/capitalization-cap-rate

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## Recapitalization

The cap rate is not to be confused with “recapitalization” which is about debt and equity and often rebalancing these which is why it is often a strategic move on the owners’ part. Recapitalization is done by selling equity (a share of ownership) in property although there are different ways of doing this, such as leveraged buyouts and nationalization – among others.

## Yield

Another common term CRE professionals use is yield. A cap rate is a type of return expressed as a percentage of the value. A yield is the difference between what the investment returns and what it costs over time, calculated as a percentage. Essentially these terms are all related to what you get back.

Investopedia has a nice recent (2021) rundown of the definitions and differences, saying: “Yield and return are two different ways of measuring the profitability of an investment over a set period of time, often annually. The yield is the income the investment returns over time, typically expressed as a percentage, while the return is the amount that was gained or lost on an investment over time, usually expressed as a dollar value”.

Another important difference is yield is a typically forecast tool and return is an actual historical amount.

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