SLATT CAPITAL

GUIDE TO CAP RATES

When it comes to investing in commercial real estate, understanding the value of a property goes much further than simply comparing property costs in the area. Instead, investors must carefully consider the cost of a property in contrast to the potential earnings of the property.

There are numerous methods used to determine whether or not a property is a sound investment, and it requires a blend of these tactics to arrive at a data-driven decision. One number that can help indicate whether or not a property is a worthwhile investment is the cap rate.

What Is a Cap Rate and How Does it Help Investors?

A cap rate—or capitalization rate—is a ratio that takes into consideration the Net Operating Income (NOI) of a property and the property asset value. The goal of a cap rate is to determine the return an investor can expect to receive from a specific property if they purchased the property outright with cash.

The cap rate also helps investors compare different real estate investments. Through the cap rate, an investor can estimate the relative value and performance of each potential investment. It serves as an almost apples-to-apples method for comparing multiple investment opportunities.

When comparing cap rates, a higher cap rate indicates a higher return and a lower risk. Low cap rates indicate a property will provide a lower return and pose a higher risk. However, it is important to keep in mind that several factors can affect a cap rate. Simply choosing an investment property based on cap rates alone is not enough. Cap rates should always be used in conjunction with other assessment methods to gain the full picture. Because cap rates are based on the projected NOI of a property, they are not always 100% accurate. This is particularly true when dealing with volatile markets. Investors should always factor in current market trends and consider the location of the property when weighing the cap rate of an investment.

How to Calculate the Cap Rate for an Investment Property

To calculate the cap rate for an investment property, an investor will need to start by gathering a few key sets of data.

First, the investor will need to know the value of the property. This is usually the purchase price and doesn't include any considerations regarding financing. The cap rate assumes that the property is purchased with cash.

Next, an investor will need to determine the NOI. The NOI is the income that will be generated by the property after deducting all operating expenses. The operating expenses that are deducted should include property taxes, insurance, utilities, maintenance, and other operating costs that might be specific to the type of commercial real estate.

This number can be tricky to determine as it requires a projection into the future. For this reason, there is always a level of risk involved in calculating a cap rate. Just because a property netted an operating income of $70,000 last year doesn't mean it will be the same the next year. The more historical data an investor can access on a property, the better this calculation can become. Additionally, the more stable the market, the more likely the calculation will remain accurate.

The basic formula for a cap rate, therefore, is as follows:

Cap Rate = NOI / Property Value

Cap rates are expressed as a percentage. For example, if a property has a value of $5,000,000 and an NOI of $500,000, the cap rate for the property would be 10%.

How to Calculate the Cap Rate for an Investment Property

Numerous factors can influence the cap rate of a property. Understanding these factors can help investors better weigh a cap rate when making a purchasing decision. The following are just a few items that should be considered:

- The economy: Cap rates vary over the years and are generally lower when the economy is good. They tend to rise during a recession when real estate costs are down.
- The location of the property: Cap rates tend to vary by different regions of the country. The supply and demand of each local market can play a huge role in the cap rate.
- The property type: Different types of properties will tend toward different cap rate spans. This is usually a direct reflection of the supply and demand of each property type. For example, as remote work increases in popularity, investors will notice a decrease in demand for office properties and a rise in vacancy rates. This will, in turn, affect the NOI of this property type and, subsequently, the cap rate.
- The upkeep needs of the property: Industrial properties and warehouses tend to have higher cap rates than offices and apartments, as their maintenance needs are much lower. Less maintenance means less cost, which directly affects the NOI of these properties.

What's a Good Cap Rate?

When comparing investment opportunities, many new investors will want to know: what is a good cap rate? What constitutes a good cap rate is actually quite subjective. There are investors who will not touch properties with a cap rate of less than 10% while others will gladly invest in properties with low cap rates. There is an argument to be made for both strategies.

Ultimately, the right cap rate will depend on the amount of risk an investor is willing to take, their long-term goals, and the location of the property. For example, in a high-demand market such as Austin, Texas, it might not be possible to achieve a 10% cap rate. However, a lower cap rate might still be a worthwhile investment based on market speculation.

Generally, a range between 4% to 8% is considered a reasonable cap rate for many investments. However, weighing additional factors is always recommended prior to making an investment. Investors should make sure to also compare properties based on the following factors:

- Localized trends: During the due diligence process, investors should carefully consider any trends that are affecting the local market. While a property may have netted a high income in past years, there could be changes taking place that will dramatically change this number. This can make the cap rate a poor estimate in volatile markets.
- The property condition: When estimating cap rates, it is also important to consider the condition of the property. Newer properties will tend to have more accurate NOI estimates. Older properties may pose higher risks of incurring major maintenance or revamp costs.
- Tenant profile: Another important factor to weigh is the quality and stability of a property's tenant base. A well-established tenant base with a low risk of changing can make an investment much less risky. High vacancy rates and tenant turnover can indicate a greater amount of risk to profits.

Talk to Slatt Capital About an Upcoming Investment

Investors who understand how cap rates are calculated are better equipped to compare numerous properties against one another. However, it is critical for investors to remember that a commercial property investment has many moving parts. For those who also need to factor in the financing process, Slatt Capital is here to help.

At Slatt Capital we provide personalized, high-touchpoint services that leave our clients feeling heard. Our goal is to help assist our clients with a greater chance of success as they consider each investment opportunity. We assist with financing all major commercial property types, including retail, multi-family, office, industrial, hospitality, and special use. We have strong correspondent relationships with a variety of insurance companies, banks, credit unions, CMBS, and agency lenders. This allows us to offer our clients a wide breadth of financing offerings.