Tweed Financial Services

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Cap Rates and Risk

Once an investor understands what a Cap Rate is and how to calculate it, he can then use it to compare properties and the risks involved. Generally the higher the risk, the higher the return, in this case the higher the Cap Rate. We see many investors "chasing income" and going for the highest cash flowing properties, but often they are turning a blind eye to the pros and cons of getting into the highest income producing property.

Let's take an example of a very low risk rental. A very popular investment is a triple net lease with a high quality tenant, such as a Walgreens or CVS. Walgreens is what we call a "credit tenant."

According to Wikipedia: A credit tenant is usually an organization with a national footprint, a large regional tenant, or a local tenant with excellent credit that may be better than their national competitors. Only larger companies are called credit tenants. A lender will offer better financing terms for a development with a certain amount of space preleased or currently leased to credit tenants.

So in other words, a credit tenant is one that has an excellent credit rating and is a very low risk for paying the lease payment. Since in the commercial real estate arena, your property value is only as good as the rental income you are receiving and the rental income is only as good as the tenant has the wherewithal to pay, the credit worthiness of your tenant is of key importance. This makes a Walgreens or a similar "credit tenant" a good candidate for a low risk investor.

Now this type of triple net lease will be one of the lowest cap rate properties as it's one of the lowest risks. Usually this type of property will be at a 1-3% lower cap rate than say, an apartment building in the same market or geographical area. Just like the risk in different bonds or dividend stocks, the lower the risk, generally the lower the yield and the lower the expected return. The higher the risk, the higher the expected return.

In a strong real estate market like we have today, there's a lot of money chasing cash flow, as the interest rates for CDs, bank accounts and bonds are so low. This "pushes" money into higher yielding assets like income properties and is pushing the values higher and the cap rates (or the yield) lower. We call this "chasing yield."

Another aspect of cap rates is geographical areas. In a strong metropolitan market like Los Angeles the cap rates will be lower than say Podunk, Louisiana. Again it's a risk/reward calculation. If you lose your tenant in LA due to going out of business (or the tenant not renewing their lease), as long as it's in a half decent area, it shouldn't be too hard to re-lease the building. But if you lose your tenant in Podunk, Louisiana and it's some small town or outlaying area, the prospects for finding another tenant are much slimmer. Therefore the cap rate will be higher in these less populated and less dynamic markets.

An investor needs to be wary of a property going for a higher than average cap rate, but with a strong tenant. It's definitely a red flag and one needs to look closely at the neighborhood of the property, or the length of time remaining on the lease and the probability of the tenant staying or leaving.

An investor moving equity from one market to another can work either for or against one and an understanding of the local cap rates can make all the difference. For example; an investor could own a multi-unit apartment in Los Angeles that has a value demonstrating a 5% cap rate. Let's say a $1,000,000 property paying net rental of $50,000. Selling that property and purchasing a property in say Memphis, TN where the cap rates are higher, maybe at 7% would increase the investor's income markedly. In this example, this investor would have gone from $50,000 a year of income to $70,000, a 40% increase in his "take home pay" with the same amount of equity.

Again, there are pros and cons to owning a property in another market. An income property in Memphis, for an owner living in LA means you need to find a competent and trustworthy local property manager. This obviously can be done, but it's another issue of which to be aware. Property appreciation is generally attributed to controlling expenses and increasing rental income, so it's important to have a manager that knows the local market and is aggressive in raising rents and maintaining the quality of the building in order to attract good quality tenants.

For a personal, private consultation, give me a call at (626) 588-1520.