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Understanding Cap Rates

By Rusty Tweed

In the commercial real estate market you'll commonly hear the term, "cap rate." The full term is actually "Capitalization Rate" and is used to compare the value of a rental property on an "apples to apples" basis to other investment properties. The term "cap rate" can only be used with regards to income producing or rental properties. You can think of cap rates as a ratio of the rental income to the value of the property. It is very important for an investor to understand what a cap rate is and how to use it.

The formula is Net Operating Income/ Fair Market Value = Cap Rate.

Or NOI/ FMV = Cap Rate

Net Operating Income (NOI) is the rent that you are collecting on an annual basis (per year) after subtracting all the normal expenses such as insurance, taxes, routine maintenance, etc. This would not include any mortgage payments, as every property would have a different amount and it would be all but impossible to compare one property to another, so for Cap Rate calculations it's always assumed there is no debt on the property.

Fair Market Value (FMV) is the current value of your property if you were to sell it. The Cap Rate is a percentage and is an easy way to compare the income and value of your property and other income properties in your area. For example: if your NOI was $60,000 (all your rental income minus your expenses for the year) and your property was worth $1,000,000 (the FMV), then your Cap Rate is $60,000/ $1,000,000 or 6%.

Now if you came across another property that was in your area and the net rental income was $75,000 (NOI) and you knew the cap rates in your area are 6%, then what is the value of the property (FMV)? Take the $75,000 and divide it by the 6% and you get $1,250,000. NOI/ Cap Rate = FMV.

Once you understand this you can value properties easily and also figure out how to increase property value. For instance using the above example, if the normal cap rate is 6% in your area, and your property is generating $60,000, if you could raise your rents to $75,000, then your property just went up in value from $1,000,000 to $1,250,000. That's the great thing I love about rental properties, the formulas are very mathematical and it's very logical to determine values.

Looking at rental properties in this manner is very similar to bonds or trust deeds/ notes. The value of the property is easy to determine just like a bond. The higher the income being generated either through interest rates or rents will increase the value of the property or the bond. Now we all have a working understanding of risk and rewards and returns. Generally the higher the return, in this case the Cap Rate, usually the higher the risk.

You'll find that newer, well-kept properties in affluent stable areas will have a lower return or lower Cap Rate. These properties tend to have more well-to-do tenants and can pay higher rents, more stable jobs and are more likely to look after the property better. Rental properties in "rough" neighborhoods will have a higher cap rate, since it may be more likely that your tenant will have a lower paying, less stable job, more likely to damage your unit and it may be harder to collect the rent. This is a higher risk property and will have more intensive management and thus a higher cap rate and higher return.

Also understand that Cap Rates and general interest rates have a relationship. When interest rates are high, Cap Rates are generally high as well. When interest rates go down, in most cases, Cap Rates will go done as well. This is very reflective of both rental properties and bonds.

Also different parts of the country will have different Cap Rates as well. For example, right now in Los Angeles, property values have been pushed up more than other parts of America and the Cap Rates on apartments are in the 4-5% range, which is much lower than most of the rest of the country. Cap Rates in the mid-west or south, say St Louis or Atlanta, are more likely to be in the 6-7% range.

Understanding this allows investors to not only increase their property values, but also allows them to strategize how to get potentially better income. We're seeing many people looking at the high value of their Los Angeles rental property as an opportunity to sell and buy something in another market where the Cap Rates are higher and thus get much better rental income than they were receiving here in LA.

If you would like more information regarding Cap Rates, or a complimentary financial analysis, please give me a call at 800-526-1599.

Robert "Rusty" Tweed is President and Founder of Tweed Financial Services, Inc., a full-service financial and estate planning firm located in San Marino, California. Tweed Financial was founded in 1991 and has offered various aspects of wealth management and financial advisory services ever since. In 1999, Robert Tweed was selected Estate Planner of the Year by the National Association of Financial and Estate Planners (NAFEP).

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