Capitalization Rates & Other Metrics

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Defining Cap Rate

If the asset is being **purchased**, the price is **established by the market**

If the asset is already **on the books** or **not currently for sale**, then **real estate asset comps** will need to be done to establish a **fair value**.

Net Operating Income

Purchase Price or Present Value of Asset

NOI for cap rate = All building related income less direct property expenses, property taxes, maintenance/repairs)

Operating income must be **stable** & should be **NEXT twelve months**

Must be **unlevered** (no interest in NOI)

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The Inverse of the Cap Rate Gives us the Multiple

$$\frac{1}{\frac{\text{Net Operating Income}}{\text{Purchase Price or Present Value of Asset}}} = \text{Multiple of Value over Earnings}$$

EXAMPLE

Operating income = 1,000
Property value = 20,000
Cap rate = 5% (1,000/20,000)

*Or we can say that the building is trading or selling for **20x earnings (1/5%) or (20,000/1,000)***

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Which is Better, a Higher or Lower Cap Rate?

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Factors Affecting Cap Rate

Macro-level Economics & Demographics	• Land availability • Regulatory environment
The Type of Property	• Each sector carries its own industry risk
Micro-level Market Influences	• Property classes (A, B, C, etc.) • Lease types (NNN, NN, N)

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Applying the Cap Rate to Investing Decisions

PROPERTY A

30 unit – Multi-family Class A	
Listing price	$1,000,000.0
Improvements required	0.0
Annual rent	108,000.0
Monthly operating expenses	(43,200.0)
Net Operating income	64,800.0
Cap rate	6.5%
Multiple	15.4 x

PROPERTY B

30 unit – Multi-family Class B	
Listing price	850,000.0
Improvements required	100,000.0
Annual rent	126,000.0
Monthly operating expenses	(42,000.0)
Net Operating income	84,000.0
Cap rate	9.9%
Multiple	10.1 x

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Issues with Cap Rate

Net Operating Income (NOI)

1. Does not factor in **leverage** which impacts the **yield**
2. Buildings with many leases below market are **penalized**
3. Does not consider **capex**
4. Ignores **value plays**
5. Buildings with **higher vacancies** are **penalized** despite potential
6. Does not **leasing commissions** or **TIs**

Purchase Price or **Present Value of Asset**

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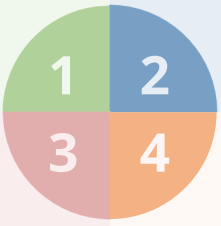
Other Important Metrics

BREAKEVEN RATIO

$$\frac{\text{Opex + Debt Service}}{\text{Gross Potential Rent (GPR)}}$$

CASH on CASH Yield

$$\frac{\text{Cash Flow After Debt Service (Levered Net Cash Flow)}}{\text{Equity Invested}}$$



LEVERED EQUITY MULTIPLE (MoM)

$$\frac{\text{Sum of CF to Equity Investors}}{\text{Equity Investment}}$$

IRR (Levered or Unlevered)

Most commonly used **valuation metric**. Complicated due to **annual cash returns to equity holders**. Use **XIRR** in Excel due to **monthly forecasting**.

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