How to Figure Cap Rate (Capitalization Rate)

The Capitalization Rate—commonly called the **cap rate**—is a quick way to estimate the expected return on an investment property. It measures a property’s annual Net Operating Income (NOI) compared to its current market value or purchase price.

Formula: Cap Rate = (Net Operating Income ÷ Property Value) × 100

Step-by-Step Example

1. **Find Gross Income**: A 4-plex generates $120,000 a year in rental income.
2. **Subtract Operating Expenses**: Taxes, insurance, maintenance, and management total $40,000 annually.
NOI = 120,000 - 40,000 = 80,000
3. **Divide by Property Value**: If the property costs $1,000,000:
Cap Rate = 80,000 ÷ 1,000,000 = 0.08 = 8%

Cap Rate Interpretation	Meaning
Higher Cap Rate (9–12%)	Higher risk, often older properties or less desirable areas, but higher returns.
Lower Cap Rate (4–6%)	Lower risk, usually prime locations or strong demand, but lower returns.

Cap Rate vs. Cash-on-Cash Return:
- Cap Rate assumes you purchase with cash (ignores financing).
- Cash-on-Cash Return considers financing costs like mortgage payments.

Limitations of Cap Rate:
- Doesn’t account for financing or tax benefits.
- Based on current income and expenses only.
- Best used to compare similar properties in the same market.

Rule of Thumb: Use cap rate as a snapshot tool to compare deals. Always pair it with other metrics (cash flow, market appreciation, debt service coverage) for a full investment analysis.