



Cap Rate on Investment Properties Explored

It's interesting that different investment real estate product types focus on different sales metrics. For example, many Apartment Investors rely on Gross Rent Multiplier (GRM), which only accounts for top line revenue and is stated as a multiplier to sale price. Cost per unit is self-explanatory and widely used. Retail, Office and Industrial Investors don't use either of those but are much more oriented toward Cost per square foot as their favored metric.

However, Capitalization rate (Stated as "Cap rate" or simply "Cap") is the best metric to get a more complete picture and allows comparison of income producing properties, no matter the product type, to one another. Many readers know what Cap Rate is, but for now, here is a simple example which we will build on:

Cap rate is relatively easy to arrive at: Annual Net Income of a property divided by Sale price. Say, Annual Net Income = \$100,000 / Sale price = \$1,800,000 = 5.55% Cap rate. Cap rate is expressed as a percentage with one or two decimal places.

The easiest way to mentally get around Cap Rate is it expresses your rate of return if you paid ALL CASH for a property. Whether you get a loan to purchase or not, Cap Rate levels the playing field for comparison and provide a barometer of the overall marketplace.

The above calculation to arrive at Cap rate is relatively easy, but using it requires more understanding. First, in a given marketplace, for example, Long Beach Apartments, there exists a "Market" Cap Rate. That is, the average Cap Rate that buildings are selling for currently. Market sale prices dictate the heaviest Cap rate movement, which register inverse to price movement. As prices increase, Cap Rate decreases and vice versa (Net income being held equal for this discussion).

It is VERY valuable to understand and track the Market Cap Rate in which you own properties or are considering buying.



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To continue the example, say the Market Cap Rate is running at 4.5-5.0% for Long Beach Apartments, which is close to what is now. When you look to compare the Market Cap rate to an individual property Cap Rate, many times they do may not match. Why?

Cap rate on a single property is analyzed between the Actual current Cap rate versus the Proforma Cap rate -- what you can improve it to in the near term, if purchased. If rents and resulting net income are below market, Cap Rate will register low, even if the sale price is within parameter. If the above net income was \$80,000, using the same sale price, the Cap rate would be only 4.4%. Can you expect to raise rents to get the Cap Rate to Market (or better!)?

Cap Rate will also register artificially high if expenses are understated. Can you underwrite the Property to true expenses and arrive at the Actual and Proforma Cap Rate? Many times, Income and Expense numbers are good but the Asking price is just too high. Through your analysis of the property, establishing Actual and Proforma Cap Rate and comparing to Market Cap Rate, you can determine how much to pay for a property or if you even should pursue it at all.

Cap Rate is a fabulous way to get a clearer picture of an Investment property, and its relation to the overall market. I've been underwriting properties and analyzing Market, Actual and Proforma Cap Rates for many years, so bring your questions, comments or scenarios my way and I'm glad to help. Please contact me below.

Thanks!

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