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Cap Rate
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What is a Cap Rate?

Cap rate defined: $\frac{\text{Year 1 Net Operating Income}}{\text{Purchase Price}}$ = Cap Rate

Example:

$\frac{\text{Year 1 Net Operating Income of \$100,000}}{\text{\$1,250,000 Purchase Price}}$ = 8% Cap Rate

A capitalization rate is the expected net operating income (after collecting all the rent and paying all the expenses except the debt service and before income taxes) divided by the cost or value of the property. Future events, beyond Year 1, are not included in the intentionally simple "cap rate."

Generally, a lower cap rate is good for sellers and a higher cap rate is good for buyers.

The cap rate excludes these items:

a) Changes in cash flow after year 1.
b) Capital expenditures like HVAC replacement, roof replacement, parking lot replacement.
c) Leasing commissions.
d) Tenant improvements not paid by the tenant.
e) Cost of the purchase or sale.
f) Real estate inflation or deflation caused by overall market conditions, changes in market cap rates and financial underwriting.

Paul McArthur, CCIM
President
Trillium Realty Advisors

What is a CCIM?

CCIM

A *Certified Commercial Investment Member (CCIM)* is a recognized expert in the disciplines of commercial and investment real estate. A CCIM is an invaluable resource to the commercial real estate owner, tenant, investor, and user, and is among an elite corps of 7,500 professionals across North America who hold the CCIM designation.

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What is a Cap Rate? (cont.)

A cap rate is a very effective and quick way to get an estimate of the value of an income producing property.

However, the cap rate does not consider the performance of the property over time.
It does not consider the affect of a mortgage.
It does not consider the location of the property, the quality of its tenants, or the length of the leases.
It does not consider expenses below NOI.

Most importantly, it does not calculate the yield, IRR or net present value of income producing real estate. For that, you need to model each property individually over time.

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