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The High-Risers Club

5.14.2024 – The World of Cap Rates

Coach Jeff Wright

Welcome

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Podcast

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- **This Week: Down Payment Differences Between Residential and Commercial Real Estate Loans and 3rd Party Expenses for a Commercial Real Estate Loan**

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Cap Rates

One of the ways investors compare investment opportunities

- Stocks
- Bonds
- Commercial Real Estate

Cap Rates

Three Types of Valuation:

- Income
- Sales Comparison
- Cost

Cap Rates

Measuring Investment Value ($I \div R = V$)

- **I** – NOI – Net Operating Income
- **R** – Capitalization (Cap) Rate
- **V** – Market Value

**If you have any two of these three numbers, you can solve for the third.*

Cap Rates

Cap (Capitalization) Rate ($I \div V = R$)

The Cap Rate is the rate of return on a real estate investment property based on the income that the property is expected to generate.

It is the return if you paid all cash.

Cap Rates

Debt is not part of the cap rate calculation.

The formula is focused on the property alone, and not the financing used to buy the property.

A cap rate assumes a property is brought for cash without leverage.

If you paid \$1,000,000 and received a 7.5% return, what would the return be?

Answer = \$75,000

Cap Rates

Question - If you paid \$800,00 for a mixed-use property and the Net Operating Income (NOI) was \$70,000, what is the Cap Rate?

$$I \div V = R$$

$$\$70,000 \div \$800,000 = 8.75\%$$

Answer = 8.75%

Cap Rates

Cap Rate ($I \div V = R$)

Question – What is the Cap Rate of a building offered for sale at \$3,000,000 that has an NOI of \$225,000?

$$\$225,000 \div \$3,000,000 = 7.5\%$$

Answer = 7.5%

Cap Rates

Cap Rates are determined based on the following:

- Risk
- Upside Potential for Cash Flow and Value
- Interest Rates
- Location
- Property Type
- Appraisers Market Comps

Cap Rates

Not all cap rates are created equal

- Overall occupancy
- Strength of the tenants
- Lease expiration periods
- Rents are the market rates or higher or lower

Cap Rates

To determine an appropriate cap rate, an appraiser will use comparable sales around the area of the subject property and will adjust the cap rate based on the specifics of the comparable properties.

Cap Rates

A cap rate is a measure of risk

- Properties with higher cap rates typically have more risk
- Similar to the bond market, the lowest yielding bond is the US Treasury, which is considered to be the safest investment you can make

Cap Rates

Cap rates are different in different market. A major city like Manhattan or LA will yield a lower rate than the exact building in a suburban area with less demand

Cap Rates

Cap Rate challenges relating to valuation:

- Cap Rate is a snapshot of the property's performance (cash flow) over the last 12 or 24 months
- Cap Rates are subjective
- It is not a guarantee of the return as no one can guarantee tenants will pay their rent and what will happen with expenses

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Next Session

Next Session:

The World of Cap Rates Pt. 2

Tuesday, May 14th, 2024

@ Noon Eastern

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