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10.12024 – The Math You Need to Know, Simplified: Part 1

Coach Jeff Wright

Welcome

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Does anyone have anything great to share personally or professionally?



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Podcast

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- **Last Week: Nine Major Differences Between Residential and Commercial Financing**
- **This Week: Residential Market Update – September 2024**

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The Math You Need to Know, Simplified

Market Value

This method is based on the IRV formula: converting a one-year stabilized net operating income (NOI) into the market value of the property. If the property is not yet built or fully occupied (has not reached its full potential NOI), the appraiser will put together a value they feel reflects the true marketplace.

$$\frac{\text{One-Year Stabilized NOI}}{\text{Capitalization Rate (Cap Rate)}} = \text{Market Value}$$

Example: Given the follow scenario, what is the market value of the property?

I = One-year stabilized NOI	=	\$54,630
R = Capitalization Rate (Cap Rate)	=	12.14%
V = Market value	=	?

$$\frac{\$18,210}{0.1214} = \$450,000$$

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Cap Rate (Capitalization Rate)

The capitalization rate is the rate of return on a real estate investment property based on the income that the property is expected to generate. Cap rate is determined by the following formula:

$$\frac{\text{Net Operating Income}}{\text{Sales Price (Value)}} = \text{Cap Rate}$$

Example: Property A has a net operating income (NOI) of \$216,000 and a sales price of \$2,700,000. Property B has an NOI of \$220,000 and a sales price of \$2,275,000. What are the indicated cap rates and how do they compare?

PROPERTY A:

$$\frac{\$216,000}{\$2,700,000} = 8\%$$

PROPERTY B:

$$\frac{\$220,000}{\$2,275,000} = 9.67\%$$

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Net Operating Income (NOI)

NOI is the income available to pay the mortgage (debt service) after all operating expenses have been paid.

If the value of the property is known along with the capitalization rate, the cap rate formula can be reconfigured to solve for the NOI.

$$\text{Value} \times \text{Capitalization Rate} = \text{Net Operating Income}$$

Example: If the value of the property is \$2,700,000 and the capitalization rate is 8%, then what is the NOI of the property?

$$\$2,700,000 \times 0.08 = \mathbf{\$216,000}$$

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	Rental Income
<i>Plus</i>	Other Income
<hr/>	
<i>Equals</i>	Total Income
	Total Income
<i>Minus</i>	Vacancy and Credit Losses
<hr/>	
<i>Equals</i>	Effective Gross Income
	Effective Gross Income
<i>Minus</i>	Operating Expenses + Reserves
<hr/>	
<i>Equals</i>	Net Operating Income

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

Question - What should an investor who is looking for a minimum cap rate of 8% be willing to pay for a building that has an NOI of \$228,000?

Answer:

\$2,850,000

$$V = \$228,000 \div 8\%$$

$$V = \$2,850,000$$

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Next Session

The Math You Need to Know, Simplified: Part 2

Tuesday, October 8th, 2024
@ Noon Eastern

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