

Introduction

The cap rate is used as a way to value income producing commercial properties. It is one of several considerations to be used when evaluating property.

The term "cap rate", short for capitalization rate, can be thought of as a "rate of return" or "interest rate". In other words, what rate of return or interest does the investor want to produce on their investment?

Different investments yield different rates, depending on risk. For instance, by putting money in the bank, it is expected to have a low rate of return, due to the fact that it is a less risky investment. With real estate investments, it is a high risk investment, therefore, a prudent investor expects a higher rate of return or cap rate.

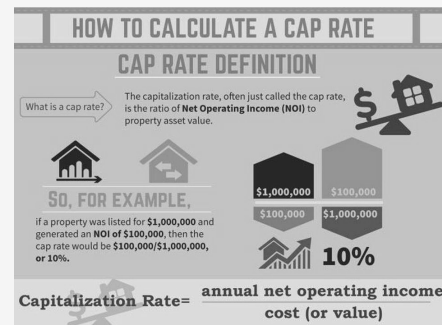
The rate of return in real estate investments fluctuates, depending on current market conditions.

A formula is used to determine cap rate, by taking income minus expenses and turning them into a ratio which shows the amount of return on investment (cap rate) to estimate the value of the income producing property.

Steps to determine Cap Rate:

1. Determine the amount of gross income the property can produce.
2. Subtract an estimate for vacancies.
3. Subtract estimate for collection losses.
4. The result is the effective gross income.
5. Subtract the operating expenses, including fixed expenses such as taxes, insurance, management fees, maintenance, utilities, etc.)
6. The result is the **Net Operating Income (NOI)**.
7. Divide the **NOI** at the current capitalization rate. (Your local commercial real estate professional will be able to tell you what current market cap rates are).

CAP Rate Analysis



Basic Capitalization Formula

The basic capitalization formula in the income approach looks like this: **Value, Rate of Capitalization, and Income**. Below is the formula:

$$V = I \text{ divided by } R; \text{ or}$$

$$V = I/R$$

Cap rate is not the only factor to consider in determining value. Analysis should take into consideration all factors contributing to the value of a particular property

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