



Property Valuation - Cap Rates – A Basic Refresher

Although real estate investors typically use more complex methods for determining the value of income producing properties, the capitalization rate, commonly referred to as the “cap rate”, is an essential tool for quick valuation calculations based on cash flow. The formula is simple - annual stabilized net operating income divided by value (or cost), expressed as a percentage. For example, if an apartment community is valued at \$100,000,000 with an annual Net Operating Income (NOI) of \$10,000,000, the cap rate is 10%. Obviously, this means the lower the cap rate, the higher the value. Therefore, a low cap rate is typically considered favorable to an investor who is selling, and a high cap rate is considered favorable to an investor who is buying. At times, adjustments may need to be made to NOI before applying the cap rate. For example, replacement reserves would not be included in NOI. The math is elementary, but real estate professionals and investors need to understand what drives the cap rate. Let’s look at the basic elements behind cap rates and what is happening with the rates in today’s multi-family market. It is always good to periodically reflect on the basics.

The underlying factor behind the cap rate is risk. Accordingly, the cap rate could be thought of as the return on minimal risk plus the risk premium of the investment. Although, technically not absolutely accurate, U. S. Treasury Bills are considered virtually risk free. The 10-year Treasury is the longest term bond currently issued by the U.S. Treasury and is considered the standard benchmark for long-term risk comparison. Generally, cap rates rise and fall in correlation with Treasury rates. Increased Treasury rates contribute to lower property valuations because future cash flows are worth less in higher –rate environments. The risk premium is referred to as the spread and is the difference in the yield between Treasuries and other investments with a similar maturity. The spread is expressed in terms of basis points (bps); one basis point is equal to 1/100th of 1%. Thus, the spread between 5% and 5.75% is 75 bps. Since risk tolerance among investors varies greatly, the risk premium component is subjective.

Treasury Rates are available daily from several sources, such as:

[10 Year Treasury Rate Chart – Ycharts](https://ycharts.com/indicators/10_year_treasury_rate/chart/)

https://ycharts.com/indicators/10_year_treasury_rate/chart/

10 Year Treasury Rate historical data, charts, stats and more. 10 Year Treasury Rate is at 1.91%, compared to 1.92% the previous market day and 2.84% last year. This...

As we all know well, real estate is market specific; therefore, cap rates vary by location. The underlying market fundamentals of the area, such as supply and demand, the job market and the health and diversity of the economy impact the cap rate. A property in a booming economy would have a lower cap rate than a similar property located in a recessed area with high unemployment.

Factors about the property itself play into the cap rate. Such factors as the age and condition of the property, the quality of the leases and the type of property impact the rate. A new urban high rise would have a lower cap rate than a 30-year old property with deferred maintenance. Let’s look at how this applies in today’s market.

- In Los Angeles, Miami and San Francisco, the institutional investor is looking for new AA Product with great location and high barriers to entry. For the right product and right location, he might be willing to accept a 4.5 cap rate. He has a longer “hold” period for his investment. His object is a safe investment for his investors that will appreciate a 4.5% return on their investment rather than a 2% return on a 10-year Treasury.

- The opportunistic investor might be looking for the B product in a convenient / safe neighborhood that can be upgraded to create the “renovated” A product. He is hoping that he can, for example, buy with a 6.75 cap rate and sell after he has improved and raised rent at a 5.75 cap rate.

Small changes in the cap rate can bring a major change in value. This can be illustrated by comparing the value of an apartment community with an annual NOI of \$1,000,000 at a cap rate of 5% and a cap rate of 6%. Using our simple formula, the valuation of the investment at a 5% cap would be \$20,000,000 (\$1M / .05) and the valuation would be \$16,666,667 (\$1M/.06) at a 6% rate. This cap rate change of only 1% equates to a \$3,333,333 (\$20M - \$16,666,667) loss in valuation.

The national multi-family market is strong overall. Currently, cap rates vary between 4 to 7.5%, depending on the quality and location of the asset. In most areas, although supply continues to increase, demand remains high so absorption is not a problem. Financing and demographic trends remain favorable. Because of the strong fundamentals, cap rates have remained surprisingly steady despite the tightening of the 10-year Treasury spread.

Although cap rates continue to be good and fundamentals are strong, we need to remain mindful of a couple of aspects. There is concern among some that certain investors are too reliant on low interest rates. If the Fed slows their purchases of Treasuries, long-term interest rates will increase with a simultaneous increase in cap rates and lower valuations. This would be problematic for investors who are selling or refinancing. There is also an increasing disparity in cap rates between markets because of differences in local economies; therefore, investors need to apply the proper cap rate for that particular area. As always, investors need to remember the basics.

Think about some imbedded formula “What If’s”? See Below.

AA High-Rise or Mixed use... Buyer



\$ _____ NOI @ _____ Cap Rate Percent \$ _____ Potential Value

A Product Mid-rise / Mixed use...Buyer



\$ _____ NOI @ _____ Cap Rate Percent \$ _____ Potential Value

B Suburban Garden Apartments....Buyer



\$ _____ NOI @ _____ Cap Rate Percent \$ _____ Potential Value