

**CAPITILIZATION RATE:
THE GREAT EQUALIZER
SPOTLIGHT PAGE**

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[Rent Roll Triangle: The Ultimate Rental Property Grading System](#)
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Cap Rates: The Great Equalizer

Definition

Capitalization Rate defined: The ratio to Net Operating Income (NOI) to asset value. Or, the ratio between NOI and Original cost (or price).

- The lower the Cap Rate, the higher the value of the asset.
- The higher the Cap Rate, the lower the value of the asset.

How to Calculate Cap Rate: Net Operating Income (NOI) divided by purchase price. Examples:

- $\$50,000/\$1,000,000 = 5.00\%$
- $\$670,000/\$10,000,000 = 6.70\%$
- $\$353,250/\$5,850,000 = 6.04\%$

What's a good Cap Rate? Contributing factors:

- Property Type
- Usage, Risk
- Demand
- Market Density (Urban vs Rural, Chicago vs Detroit or SFO vs Sacramento)
- Costs of Capital (Hurdle Rate)
- Credit Availability

For Cap Rates comparisons to have any value in making investment decisions... you must use equal standards to compare – this is true whether its property or markets.

Variables – Lying with Statistics (don't lie to yourself)

- Two properties in the same submarket – one cap rate is derived adding in management fees and the new real estate tax rate at transfer, one cap rate is derived EXCLUDING management fees and USING current real estate tax rate. This cap rate comparison will deliver two COMPLETELY different valuations for the same asset. Avoid this by doing everything you can to create real and fair comparison's.



Projecting Value from Cap Rates – Time Value of \$

- Walnut Trees – 40 years, no earnings, then huge pay out.
- Date Stamped Certificates – earns for a period of time, then yield goes to zero

When reviewing cap rates always take market dynamics into consideration

- Buyers' market vs Sellers' market (AKA as Investor sentiment)
- Rent growth rates
- Availability of financing

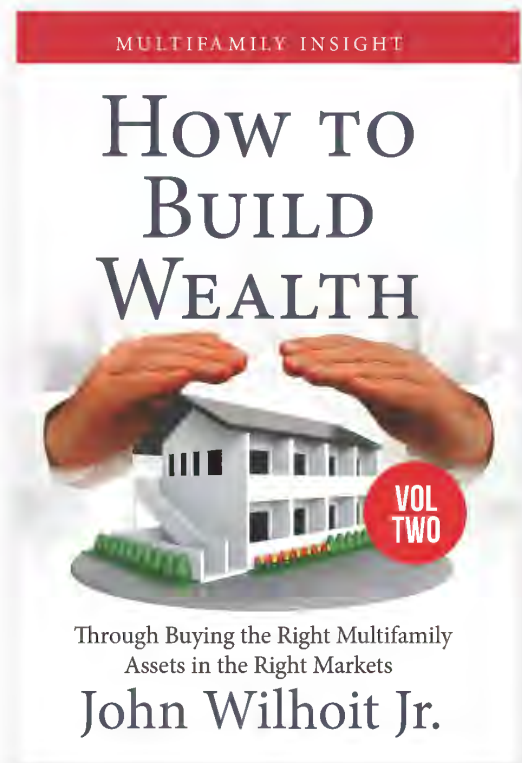
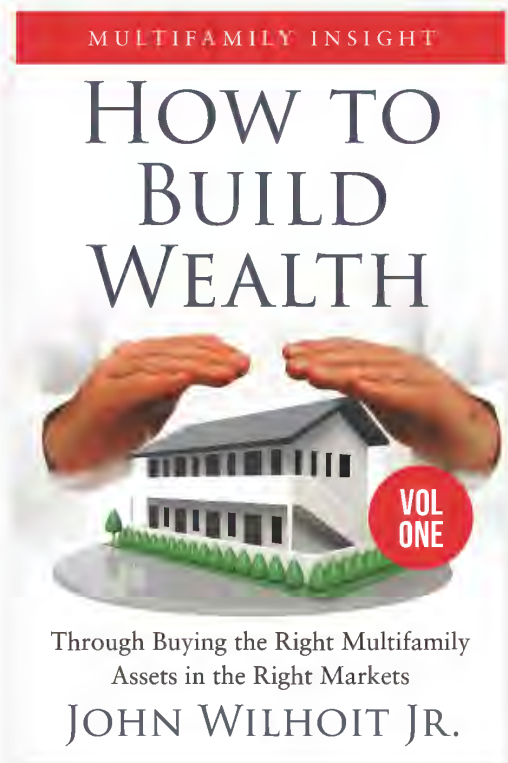
How Often to Review Cap Rates on Owned Assets

- At Purchase...
- At least annually
- Pre-disposition (or Sale)... before taking a property to market

Brass Tacks

- Use Cap Rates as part of acquisitions due diligence
- Cap rate should be part of your annual business plan for each owned asset

PUBLISHED BOOKS



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