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Alaska REAL ESTATE BY DAVE WINDSOR

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What Is All The Fuss About 'Cap Rate'?

'Cap Rate' is a term you may hear when it is referring to a commercial investment – which can be anything from a duplex to apartment complex to a shopping mall, or a full-sized business opportunity.

The Capitalization Rate is the return on your investment. In short, what is the percentage return per annum on the amount of money you invest to acquire the asset?

The Cap Rate is the Net Operating Income (NOI), before allowing for any Debt Servicing (i.e. your loan repayments if any), as a percentage of the Purchase Price, and before Taxes.

You may be paying Cash, or you may be borrowing money to purchase the asset, but that does not affect the Cap Rate. The Cap Rate is the return on your investment. How you obtain the money to make the investment is your choice.

Let's take an 8-plex priced at $500,000. Gross Rent is $80,000 and there is $2,400 also derived from the coin operated laundry. Deduct an allowance for Vacancies (i.e. empty units from time to time) - 5% is a good rule of thumb unless you can measure accurately based on the past. Gross Income is, therefore, $80,000 plus $2,400 less $4,000 = $78,400.

Expenses must include Property Taxes, Insurance, any Utilities paid by Owner, Water & Sewer, Trash Pickup, Ground Maintenance, Property Management (if any - usually costs between 6% and 8% of rents if you want to hire it out) and, lastly, Maintenance - a difficult figure to project, but use 4% of Rents as a rule of thumb.

Let's say expenses total $35,000. NOI is, therefore, $78,400 less $35,000 = $43,400 - - - - or 8.68% of the Purchase Price of $500,000. This is the Capitalization Rate: 8.68%. Not bad!

The same principle exists for any commercial acquisition. You might, for example, be acquiring land and buildings with a Pizza Hut leasing it and operating independently. The calculation would be the Income from the tenant (Pizza Hut) less all the expenses as above to calculate NOI.

Now, in the case of the duplex or the land & buildings leased to Pizza Hut, there are a three expenses that can make or break your operation:-

First is the vacancy factor. Can you keep the units full, and will you have to evict tenants for not paying? In the case of the

Pizza Hut type of deal a professional Appraiser will factor in a 3% vacancy and credit loss factor. **Secondly, how much will maintenance cost?** A thorough inspection before buying is critical to help you estimate what you will need for maintenance. If you do the work yourself, it will obviously cost less. On the larger business deals a 1% to 2% reserve for maintenance is usually assumed. Smaller investments such as the Duplex will be higher 3% to 4%.

Third is the question of whether you hire a Property Manager. This costs a significant slice of your rental income but can work out on complexes of 8 or more units. You may even do a deal with someone who occupies the property, rent-free, in exchange for collecting rents and doing minor maintenance. On large commercial operations, management costs are usually estimated at 1%.

So, now you have a Cap Rate, after allowing for average maintenance per year, whether you may lose some rental income from vacancy or credit losses, and whether you have a professional management fee.

What is an acceptable Cap Rate? 5% Cap Rate would be the bare minimum you would want to receive on a business investment. Otherwise, you might as well invest it without all the hassle in stocks and bonds. Around the United States professional investors may well see 5% to 6% as okay for their trouble, but Alaska generally requires a higher rate of return for savvy investors.

In my view the 6% to 9% range should be sought. If you can obtain a 10% Cap Rate that would be a slam dunk.

Consult your Financial Advisor or commercially qualified Realtor before putting your money into what could be a losing project. Your CPA could also advise but only a handful of us with Real Estate licenses are educated to this level.

NOTE: It should also be noted that there are two other distinct financial advantages to commercial investments, and possibly a third.

First, the Tax advantage of depreciation which your CPA will advise may be accelerated to reduce your taxes in the early years of your project. Depreciation is a legitimate business expense but not factored in to the NOI and, therefore, does not affect Cap Rate.

Second, your asset may well 'appreciate' in value while you are 'depreciating' it for taxes. What you pay $1 million for today could well be worth $1.5 million in 5 years time. Cap Rate does not include this benefit.

Thirdly, if you borrowed money to acquire the income –producing asset, your payments, though not in the Cape Rate calculation, are steadily increasing your equity in the property as you reduce your debt.

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