



What's a Cap Rate?

And How Is It Used To Estimate Sales Prices For Commercial Properties?

by Charles Porter

Real estate agents who practice commercial brokerage are quite familiar with the term *cap rate*, which is short for *capitalization rate*. The term can be confusing to agents who do not participate in commercial brokerage, and it's a mystery to most in the general public. However, it is a simple concept and a valuable tool in estimating sales prices of commercial properties.

Commercial practitioners assist their clients by developing competitive market analyses or broker price opinions to determine a reasonable estimate of sales price for any particular property, just like residential practitioners do for homes. The income approach using capitalization of income is one of the three traditional methods to determine the estimated sales price of commercial property, the other two approaches being comparable sales and replacement cost.

Definition of Cap Rate

The relationship between a stream of net operating income (NOI) and value of a commercial property is the essence of the income approach. The income approach is arguably the most significant immediate indicator of what a property's closed sale price could be. Why? Because often buyers or investors are most concerned with the net operating income generated by a commercial property, more so than the replacement cost. The comparable sales approach informs the investor's decision to purchase as well, but using cap rates with the income approach to value can provide important information that comparable sales cannot.

The direct capitalization method is the method used most often in the income approach. An important part of this method is choosing the cap rate to use. What is capitalization? It's the process of converting an income stream into a present value. The capitalization rate is the percentage by which the annual net operating income stream is divided to reach the estimated present value.

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How to Use the Cap Rate

Think of a cap rate this way: Assume an investor has a \$1 million certificate of deposit paying 4% annual interest. The amount of interest received is calculated by multiplying \$1 million times 4%, resulting in \$40,000 of interest earned that year. Most of us have done similar calculations all our adult lives. To work that equation from another angle, consider how much money must be invested in the certificate of deposit to generate \$40,000 income at a 4% interest rate. The same equation is used to divide \$40,000 by 4%, the result of which is the \$1 million amount that must be placed in the certificate.

Now apply this type of calculation to a commercial property that generates \$40,000 per annum in NOI to determine what the estimated sales price should be. The buyer/investor determines that 4% is a comparable capitalization rate to other similar properties sold recently in the area (or that 4% equals the rate of return required or desired). The same equation applies. Take the \$40,000 in NOI and divide it by 4%, resulting in \$1 million as the maximum amount the investor could pay for the property and enjoy the 4% return. The cap rate chosen can either be the cap rate used by comparable sales in the area or represent the investor's desired return.

Notice how the chosen cap rate can result in quite different estimated sales prices for the same NOI of \$40,000 per year. Assume that instead of the 4% cap rate used in comparable sales, the investor desires an 8% return and uses 8% as the cap rate for analysis. Following the same calculation process, take \$40,000 in

net operating income and divide it by 8%, which results in \$500,000 as the maximum amount the investor could pay for the property in order to receive the desired return. That's 50% less in sales price than with a 4% cap rate.

Keep in mind that the cap rate is chosen at the sole discretion of the buyer/investor. (Appraisers are not allowed this discretion, nor are brokers developing a competitive market analysis or broker price opinion; they must use comparable sales-derived cap rates in most cases unless they fully disclose why they chose to ignore comparable sales-generated cap rates.)

Fundamentally, determining the characteristics of the prospective property to discover which other properties are truly comparable requires both accurate statistical research and the wisdom of experience. There is nothing more misleading to estimating a probable sales price than using comparable sales that are not credible.

Developing Comparable Cap Rates

Oftentimes, the NOI of a sold property is reported along with the closed sales price via our reliable MLSs. To determine the cap rate using an MLS, one simply divides the net operating income by the sales price of each reported closing. The agent can then generate a list of cap rates to assist the investor/buyer in determining the market cap rate to use in making the first offer for purchase of the property. There are also other services available to agents to find market cap rates across the nation. One service used by many commercial agents is the

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Coldwell Banker Real Estate Cap Rate Surveys, which can be found by searching the term *cap rates* at cbre.com. Members of Texas REALTORS® can also access the commercial dashboard of MarketViewer to find cap rates for many property types. (Visit texasrealestate.com/marketviewer and click the red Report Menu button to find the commercial dashboard.)

As real estate license holders in Texas, we cannot use the word *value* in our broker price opinions unless we also hold an appraiser's license, per TREC Rule 535.17. The rule also requires the license holder to provide as part of the broker price opinion the following written statement in at least 12-point type: "This represents an estimated sale price for this property. It is not the same as the opinion of value in an appraisal developed by a licensed appraiser under the Uniform Standards of Professional Appraisal Practice."

Standard of Practice 11-1 of NAR's Code of Ethics also lists several requirements for REALTORS® providing an opinion of price, including having knowledge of the type of property being valued and being familiar with the area where the property is located.

Cap Rate or NOI: Which is More Significant?

When determining the estimated sales price using the capitalization of income method, which is the more significant element: the cap rate or the accurate net operating income? Since the cap rate chosen is at the sole discretion of the buyer/investor, the more important element is likely to be the accuracy and truth of the NOI of the property. In my work as an expert witness across Texas and the nation, I have witnessed juries and even some judges focus more on the chosen cap rate at the expense of the accuracy of the net operating income generated by the property. However, NOI accuracy is essential.

Let's say the argument is between the use of comparable market-based cap rates of 7% versus 7.25%. If the NOI of the property is \$40,000 per year, then the indicated estimate of the sales price using a 7% cap rate is \$571,429, while a 7.25% cap rate equates to a sales price of \$551,724, a difference of around \$20,000 in the estimated sales price of the property.

However, if the \$40,000 is an inaccurate NOI and the true NOI is \$30,000, the indicated sales price at a 7% cap rate falls to \$428,571; using a 7.25% cap rate at \$30,000 NOI, the indicated sales price drops even lower, \$413,793. The \$10,000 difference in NOI results in a significant diminution of the estimated sales price ranging from \$138,000 to \$143,000. The cap rate chosen in this example pales in significance to the accuracy of the NOI because the NOI more significantly impacts the estimated sales price.

Likewise, watch closely for properties that use pro forma NOI instead of actual NOI. In my view, prudent agents will advise their buyers/

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investors to not only review the rent roll of the property being considered but also to review each and every tenant lease file. Review not only the lease itself; review *all* the contents of the file. Also, advise the client to seek professional help in reviewing closely the total income and expenses of the property to confirm the actual NOI. This type of in-depth analysis likely will require the assistance of an accountant and full access to the property's financial records.

The Cap Rate As An Indicator of Risk

Another use of the cap rate is as an indicator of the risk in purchasing the property based on the financial condition of each and every tenant. Financially strong tenants such as publicly traded companies are more likely to honor the financial terms of their leases, hence a lower cap rate would be appropriate to use. Tenants that are financially weaker should be assigned a higher cap rate. Remember, the higher the cap rate applied to the NOI, the lower the estimated sales price.

The best indicator of an interest rate for a risk-free investment short-term is the United States 10-year Treasury Note or T-Bill. As of the day I'm writing this, that rate is 3.67%. Unless the U.S. government fails to honor payment of the interest and/or repayment of the principal, the investment is truly safe. Therefore, any wise investor in a commercial property will demand a return and choose a cap rate in excess of the risk-free rate of the 10-year T Bill.

Other Factors Come Into Play

Is the chosen cap rate the only factor the buyer and seller should consider when arriving at the final sales price for a commercial property? Of course not. There are other, more in-depth analyses using discount rates in discounted cash flow and in net-present-value analyses of income streams. However, the cap rate applied to the net operating income is almost always the starting line for price negotiations in commercial transactions.

The cap rate is not mysterious or difficult to use and is a valuable tool in estimating sales prices of commercial properties. ✦



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How to work with
homebuilders p. 12

Cap rates and commercial
real estate p. 28

1031 exchanges

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- 4 Disconnect to better connect
Is that can of paint still good?
- 5 Assume nothing about what your clients know
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LEGAL & ETHICS

- 6 Protect yourself from disputed-value claims
- 7 Fact or Fiction: Should inspectors note whether a roof needs gutters?
- 8 Code of Ethics changes for 2023
Your Forms:
Wire Fraud Warning (TXR 2517)

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- 31 Team up with your REALTOR®

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- 32 Build lasting relationships with clients

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28 FEATURE
What's a Cap Rate?

by Charles Porter

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12 FEATURE
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by Joe Olivieri

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