Cap Rate Analysis Cheat Sheet

WHAT ARE CAPITALIZATION RATES?

If you are familiar with the financial world, you may have come across the term "return on assets." Capitalization rates, or cap rates, are similar in nature, but they are very specific to real estate investments. The formula for the cap rate is simple, but I've found that it's a concept not easy for my students to grasp intuitively.

$$\text{CAP RATE} = \frac{\text{NET OPERATING INCOME}}{\text{CURRENT MARKET VALUE OF ASSET}}$$

HOW DO WE APPLY THIS?

Assume a property has a calculated NOI of $610,000 and an asking price of 9.5 million. How can we use this formula to help determine the value of the property?

ASKING PRICE: $9.5 MILLION

NOI: $610,000

$160,000 / $9,500,000 = 0.064 OR 6.4%

The cap rate for this property is 6.4 percent; the asking price is roughly fifteen times what the property can earn in a year. On its own, the cap rate doesn't tell us that much, so we need to look at the market and the current rates for different classes.

For this example, let's assume a 6 percent cap rate indicates a Class A or Class B property, depending on the amenities and age of the facility. Hypothetical cap rates per class for the region are:

CLASS A: 3% – 6% **CLASS B**: 5% – 9% **CLASS C**: 8% – 12%

This prospective property has exceptional modern office space with some high-tech amenities in place for automation and robotics. Since it is most comparable to other Class A properties, this property is also graded as Class A. The value of the property gives us an advantage: the potential to attract better clients and earn more rent. The newer facility costs Neil less money than what he would have to pay in other markets for comparable properties.

ASSETS AND CLASSES

Commercial property has a simple grading system that applies to all asset types, such as retail, industrial, and hotels.

The system, which is not definitive or objective, is based on the overall characteristics and quality of the property. It's a great way to gauge a property's relative competitive position and how it holds up against similar properties in the market. It factors in the rent you can collect, the age of the property, value appreciation over time, and amenities.

Although the grading system is universal, there is no standard description of what an A, B, or C grade means. Brokers and investors typically use comparable properties to assign a grade. Buyers will argue the grade down ("I think this is a B+"), and sellers will tend to skew it higher ("I think it's closer to an A-"). Listing brokers will often research properties with similar amenities and age to create a set for comparison. The rating is often a dialogue between buyers and sellers, who agree to a grade based on how the property compares against other options in the market.

But it's a good starting point, nonetheless. It's tempting to think that A-graded properties are better than B-graded properties. Investors have discovered that the grade of a property is no guarantee of the income it will generate. A-grade properties often slip into B-grade status over time, gradually losing rental income along the way. Another important note is that you can have a Grade A property located in a Grade B market, and that location may effectively lower the grade. You have to factor in both the performance of the current market and the amenities that the property offers.

In terms of purpose of use, if a property is Class A, then it is usually already achieving its highest and best use, while Class C properties almost always require a complete overhaul to bring them up to market standards. Chasing better returns with lower-grade properties means accepting that trade-off of a higher risk profile.

What level of risk are you willing to accept?

Do you prefer long-term sustainable and stable income? Or would you like to take on more risk in order to make a huge return on selling the investment after major renovations?

CLASSES	
CLASS A	These are the top-tier properties in premium locations. You'll find that these properties are usually very new, with modern designs and materials. They come with high-end finishes, technology, systems, and amenities. You could call these "trophy" properties; they achieve the highest rents and better-quality tenants, and they tend to have the lowest vacancy rates. But they are also pretty expensive because of those factors. We'll discuss the metric shortly, but Class A properties also have very low capitalization, or "cap" rates, and low yields. These investments tend to offer stable returns and good cash flow over longer periods of time.
CLASS B	Class B properties are the middle-tier investments. The locations are not as highly trafficked or as visible as those of Class A. Some are former Class A properties that have aged out of that top-tier class. They're "middle of the market" properties with good construction and design, good finishes, adequate technology and amenities. Class B properties are generally a little older and less useful than Class A investments. There will usually be some upgrade potential, but they're not unusable in their current condition. With some restorative work, investors can achieve higher rents and attract a reputable tenant base. Vacancies remain low to moderate in this class. Moderate cap rates and yields typify this riskier investment, and there is potential for good returns with more work and operational effort.
CLASS C	There is no doubt about what's considered a Class C property. They are at the lowest tier, in the worst locations, and they are generally almost obsolete in function. In terms of construction, technology, and amenities, they are the worst option in their current state. They don't command good rent. They almost always require upgrades and renovations. The tenants they attract are typically poor and short term. Vacancies are felt keenly in these properties with very high cap rates. They have the highest yields and the best returns available in the market, but that expected return is a tradeoff for accepting higher market, construction, and financial risks.

CAP RATE ANALYSIS MATRIX

	CAP RATE FALLING	CAP RATE FLAT	CAP RATE INCREASING
AT HISTORIC **HIGH**	**Opportunity zone**. Cap rates decreasing (prices going up vs NOI) after historical highs is a clear sign the market has turned and is heading towards a recovery.	**Opportunity zone**. Cap rates flattening out after historical highs (lowest prices vs NOI) is a sign the market has reached its trough. Opportunity for upside lies ahead.	**Potential entry point.** Well into a recession and still some more pain left. Assets are still getting cheaper but likely nearing end of retraction and could start presenting great entry point.
AT HISTORIC **AVERAGE**	Well into recover when the market is transitioning from a recovery (above avg cap rates) into an expansion (below avg cap rates)	Depends on which direction it was coming from to determine where it is going, but appears market is stabilizing near historic levels.	This is usually when the market is transitioning from a boom (below avg cap rates) into a recession (above avg cap rates)
AT HISTORIC **LOW**	**Caution.** Market is still going up but likely not much runway left. This is when investors who get greedy get into big trouble.	**Danger zone**. Cap rates flattening out after historical lows is a sign the market has reached its peak. Next step is for cap rates to start going up.	**Danger zone.** Cap rates increasing (prices going down vs NOI) after historical lows is a clear sign the market has turned and heading for a retraction.