

Four Kinds of Cap Rates: Will the Real One Please Stand Up?

by Allen Cymrot

Throughout the ages the value of income property has been affected by many different vogues (taxes, inflation hedge, replacement costs, etc.). These vogues come and they go. Ultimately, the value of income property is decided by the fact that income property is a business. Thus its value is determined by the bottom line. Bottom line earnings are the ultimate determining factor of value for income properties. However, as today we are without the benefits of excessive artificial returns created through tax deductions, bull markets resulting from long-term shortages of real estate, and excessive leverage from easy credit, earnings are more important than ever. The capitalization rate is how you measure the income property's operating bottom line.

The capitalization rate is the income property's yield on an all-cash basis. The rate is computed by dividing the net operating income (NOI) by a proposed market value (appraised, valued, purchased, or sales price). The value of an income property is computed by dividing the NOI by a proposed capitalization rate.

Net Gain believes the capitalization rate is the most important financial element for determining the value of income property. The influence of the present and future values of income property is so overwhelming that NetGain has made it the centerpiece of its National Income Property Index (NIPI).

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The critical number for computing a capitalization rate is the NOI. This number is composed of two dollar amounts (income and operating expenses) that are subject to different interpretations and applications. Because these differences can have a profound affect on value, NetGain has decided to dedicate this article to explaining how these differences can happen.

Recently, I had a conversation with the manager of a large pension fund. He proudly announced that he had purchased a trophy piece of real estate in a prime location at a six-plus capitalization rate. I congratulated him, and then I asked, "On what basis was the capitalization rate computed?" He returned my question with a blank stare.

The purchase was large, involving a great deal of money, and the key to determining the purchase price was the capitalization rate. Yet this pension fund manager didn't know the assumptions behind his six-plus capitalization rate.

His stare went from blank to worried when I told him that the same property could have four or more capitalization rates. They are all valid; it just depends on the retirement program's needs and financial objectives to determine which is appropriate to use.

By this time my pension fund manager was entitled to some sort of explanation. I reminded him that the key number to compute a capitalization rate is the net operating income (NOI). The following represents four different time frames that can be applied to one NOI number, each resulting in a different capitalization rate.

1. Is the number being used last year's NOI?
2. Is the number being used last month's NOI annualized?
3. Is the number being used from a 12-month forward pro-forma?
4. Is the number being used three months back added to three months forward and

then annualized?

I further pointed out that since the NOI is the result of subtracting expenses from income, it is imperative to qualify those two numbers. The objective is to verify that you are using numbers that accurately represent the operation of your real estate. The income side of the profit-and-loss statement could cause that income to be artificially more than a representative number. That is why extensive, knowledgeable due diligence is a required prerequisite to all real estate purchases. The following are some examples that illustrate this point, and would immediately change the capitalization rate.

- The total income for that time frame may include non-recurring income.
- The time frame being applied might exclude rebates and/or discounts that the lessee is contractually entitled to.
- Do the current leases have annual rate increases that are consistent with future expense projections?
- The time frame being used might not show a large number of leases that are expiring at the same time.
- How do the rental rates of expiring leases compare to the current market?
- How long are delinquent accounts receivables being carried? It might be time for a writedown or write-off.

The expense side of the profit-and-loss statement could appear artificially lean through accounting methods, time frames, and management philosophies. Some of those methods are illustrated in the following progressive sequence: One of the first qualifications that has to be determined is the accounting method for expenses. Are expenses being shown on a cash basis, accrual basis, or some combination of both? Once the accounting method is determined, then the next series of questions becomes determined. If there are certain expenses that are being carried on a cash basis, then you would be looking for those changes that are not within your time frame. There may be cash outlays that are gray as far as being expensed or capitalized. Preventive maintenance programs should be examined for slowdowns or stoppage. Sometimes cash flow is just deferred maintenance. About this time I pointed out to the pension fund manager that this is only a brief summary of the due diligence that is necessary to evaluate and conclude an accurate capitalization rate. Since it was confession time, I prompted the portfolio manager to fill in some more of the details from his transaction.

The fund bought a relatively new 110,000 square foot office building. The cap rate was 6.15 percent. The income and expense assumptions behind the NOI were based on a 12-month forward pro-forma. No adjustment was given for a significant lease expiring eight months into the holding period. The building was 88 percent occupied, with a financial guarantee creating NOI equal to 95 percent occupancy. The additional NOI being created by the financial guarantee carried no adjustment of the price. There was no adjustment for future leasing commission expense for the vacant space. There was no clear cut explanation covering the cost of tenant improvements for unleased space. Some of the leases were given early concessions, which when amortized over the term of the lease reflect a lower general rent. This lower amortized rent could be more reflective of the current market.

The unfortunate result of the purchase described above is that most often stated quote: “The first year cash flow didn’t meet our expectations,” followed by, “maybe we paid too much.”

I don’t know if he was the exception or the rule, but I do know one pension fund manager who will never again accept a capitalization rate at face value.

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