

Best Practice for Success

Metrics for Investment Property Evaluation – Cap Rate

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This is a continuation of my series on best practice for success in residential property management. This one applies to one of several metrics for evaluating investment properties, cap rate. In future blogs, I will discuss cash flow, cash on cash return and gross rent multiplier all of which are important metrics to consider.

Cap rate (or capitalization rate) is a value represented as a percentage that measures the relationship between NOI (Net Operating income) of a residential income property given its current value. It considers income, operating expenses and vacancy rate and can verify property's ability to pay off a mortgage. These rates vary from area to area and for type of property (e.g., single family homes vs. 3-4 plex). Income and Expenses (part of NOI) are not often correct and can be hard to evaluate. For example, rents are calculated as actual or market rate (theoretical). Market rate rents are up, but may lag in the market values given lease expirations, etc. And, what if the property has undergone some improvements recently? This could affect expenses / NOI. Some brokers NOI figures inflate market rents to get to a target cap rate, these rents and expenses are often not realistic even in today's market. Cap rates only applies to like properties, one should not compare a single-family home to a 2/4 plex. Cap rate also focuses at a specific time frame, certain classes of properties (A, B, and C). Cap rates for me are great for like properties in the same area when used with other metrics.

Here is an example! An investor I know bought a 3/2 265k town home, 1400 SF trying to rent it for \$2500/mo. or a 7% cap rate. It has been on the market for weeks in a rental market the favors landlords! It is in a great area with good schools and the property is in good condition. Market rent is 1650 - 1750 a month rent. The market just will not support that much rent at this time! So, he is helping everyone in the area rent their homes and town homes. Or, perhaps he is not serious about renting it, perhaps a short-term hold pending some 1031 exchange, or other reason. If he wants to rent it, he needs to change to a 5% cap rate +- which is realistic.

If you, your friends, or family need a professional Property Manager / Realtor® that knows how to evaluate investment properties, please contact me.