



**CAPITALIZATION RATES AND THEIR IMPORTANCE  
IN REAL ESTATE TRANSACTIONS  
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The purpose of this short article is to define what a capitalization rate is, how it is calculated in the marketplace, and to demonstrate the importance of this measuring device to participants in the real estate market.

A capitalization rate can be defined as follows:

“Any rate used to convert income into value”<sup>1</sup>

The cap rate is really a process of converting a stream of income into present value. This is done by dividing the future income by a capitalization rate. Here is a basic example to use.

*Example:*

A real estate investor wants to purchase a retail property with a forecasted first year net income of \$50,000. The investor has established a cap rate requirement of 9.0% which is based on other retail properties in the area and his own investment criteria/expectations.

Therefore, the investor would consider the following price to pay for the property:  
 $\$50,000 \div 9.0\% = \$556,000$  (rounded).

The other use of the capitalization rate is to measure investment performance. In other words the cap rate can be calculated by having a price of the property as well as the first year forecasted NOI.

*Example:*

A real estate investor is considering the purchase of an office building that is priced at \$425,000 and has an expected annual net income of \$40,500 or  $\$40,500 \div \$425,000 = .0952$  or 9.5%

As can be seen from the previous two calculations, the cap rate is intertwined between price and net income. The following formula is often called the “IRV” method and is shown here:

Where:			
I	V	=	Investment Value
R	= $\frac{I}{V}$	I	= First Year Net Operating Income (NOI)
	V	R	= Overall Capitalization Rate (Cap Rate)

<sup>1</sup> Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 4<sup>th</sup> ed. (Chicago: Appraisal Institute, 2002), 41.

There are some very important points to consider about a Cap Rate and Real Estate Yield or Investment Return. Some investors use the cap rate to make a supposition that the overall cap rate *equals* their return on the investment. The cap rate does not necessarily parallel the yield rate of the investment. Yield rates are measured by the purchase price of the property and the amount of net income and final sales price (at the end of the investment period) of the property. If the net income and/or final sales price (at the end of the investment period) increase as compared to the acquisition price than the cap rate will be *less* than the yield rate. Conversely if the net income and/or final sales price (at the end of the investment period) decrease as compared to the acquisition price than the cap rate will be *more* than the yield rate. Finally if the net income *and* the final sales price (at the end of the investment period) stay the same then the cap rate will be *same* as the yield rate.

Lastly, the cap rate is typically estimated by the degree of perceived risk. It is typical to see higher overall capitalization rates with less desirable properties and lower capitalization rates with more desirable properties. Estimating cap rates as a measure of pricing a property requires good judgment and keen knowledge of local markets. The most important items to consider include such things as the condition of the property, lease terms, age of building, rental escalations, vacancy factors, as well as strength of tenant(s).

To help our clients, Swisher Commercial has begun to monitor and analyze local capitalization rates in the Ann Arbor area. On a regular basis we will be posting the results of our research on our website for your use. We want to make sure that all of our clients are well informed when making investment decisions. Please call our office if you have any questions regarding information on cap rates or investment returns.