

DIRECT CAPITALIZATION

Direct capitalization is a process of converting a stream of future income into a present value by dividing a future income amount by a capitalization rate (Cap Rate). In other words, the Cap Rate is the ratio between price (purchase price) and the first year income (net operating income or NOI) of the property. NOI is the money remaining at the end of a year after all the expenses are paid, not including any expenses for debt, depreciation, or income tax. An appropriate allowance for vacancy and management would be used, as well as all property taxes, insurance, maintenance, and operating costs.

$R = \frac{I}{V}$	Where:	V	=	Investment Value
		I	=	First Year NOI
		R	=	Cap Rate

Example:

A property sells for \$500,000 and at the time of sale the NOI was \$45,000. Therefore the formula to derive the cap rate is:

$R = \frac{\$45,000}{\$500,000} = .09 \text{ or } 9.0\%$
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The calculated cap rate can be compared to a buyer's cap rate requirement to determine if the property will be purchased at the given price.

Given the relationship of income to value, generally speaking as values rise cap rates will correspondingly fall. Conversely, as values decline cap rates will correspondingly rise.

Note: For information on Cap Rates or other real estate investment information please contact an Agent at Swisher Commercial.