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Three common mistakes in cap rate calculations

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Don't assume your clients fully understand capitalization rate (cap rate) analysis. Cap rate is an important concept in commercial real estate, but because of its common usage and simplification, there may be misunderstandings that lead to missteps in using it as a valuation tool.

1) Inaccurate NOI Projections. The formula for calculating cap rate is simple. Net operating income (NOI) divided by sales price = cap rate. NOI is the income less operating expenses. The expenses do not include financing costs or capital improvements. Adequate due diligence is necessary to realistically project the expenses for the coming year. Let's look at a property that sells for $1 million with $900,000 in projected expenses leaving an NOI of $100,000 resulting in a 10% cap. If the first year expenses are 5% higher than projected, it would result in an actual NOI of $55,000 and a 5.5% cap. ($1,000,000/55,000)

2) Cap Rate and Yield (IRR) are not synonymous. Cap rate is a one year snap shot showing the relationship between income and price. In most cases the cap rate and IRR (internal rate of return) will not be the same as yield must consider a return of the initial investment. Here is one of the few scenarios where they are the same. Purchase price $1 million, first year NOI $100,000. Sell the property at the end of the first year for $1 million. In this case the cap rate is 10% ($100,000/$1,000,000) and the IRR is 10%. Let's change the selling price at the end of the first year to $1.05 million. The cap rate is 10% but the IRR is 15%

3) Using a Single Cap Rate in Mixed Asset Class Properties. An example is a strip center with a AAA national tenant as the anchor and the remainder tenanted by local entities. This is a situation where multiple cap rates are probably apropos; you would use a lower cap rate for the national tenant's income stream and a higher rate for the remainder of the tenants in the center.

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