

The Use and Selection of Cap Rates

Basic Cap Rate Valuation

Cap Rate Calculation

Cap Rate = Stabilized NOI/Value = 1/Multiple

Multiple = Value/Stabilized NOI = 1/Cap Rate

Value = Multiple*Stabilized NOI = Stabilized NOI/Cap Rate

Note an "8 cap" = .08 = 8% = 12.5 Multiple

Cap Rate Calculation

Cap Rate = Stabilized NOI (yr 1)/Value

Value = Stabilized NOI (yr 1)/ Cap Rate

Summary

Information

Yield on 10 Year T Note	3.60%
Risk Premium	100 basis points (bp)
Cap Rate	3.6%+100bp = 4.6
Multiple	1/.046 = 21.7x
NOI	\$3MM

Valuation

With Cap Rate	3/.046 = \$65.2MM
With Multiple	3 * 21.7 = \$65.2MM

Gordon Growth Model: Simple Cap Rate Estimation

Growth and Discounting*

Value = (NOI) / (discount rate – growth rate) = NOI/Cap

Therefore: CAP = (r - g)

**Unless stated otherwise assume Stabilized NOI*

Summary

Information

Discount Rate	4.6%
Growth Rate	1.0%
Gordon Calculation	$1/ (.046 - .01) = 27.8$
Multiple	27.8x
Cap Rate	$.046 - .01 = .036 = 3.6%$

Summary

Information

Discount Rate	5.6%
Growth Rate	1.0%
Multiple with growth	$[1/(r-g)] = 1/ (.056 - .01) = 21.7x$
Multiple with no growth	$[1/r] = 1/ .056 = 17.9x$
NOI this year	\$3 MM

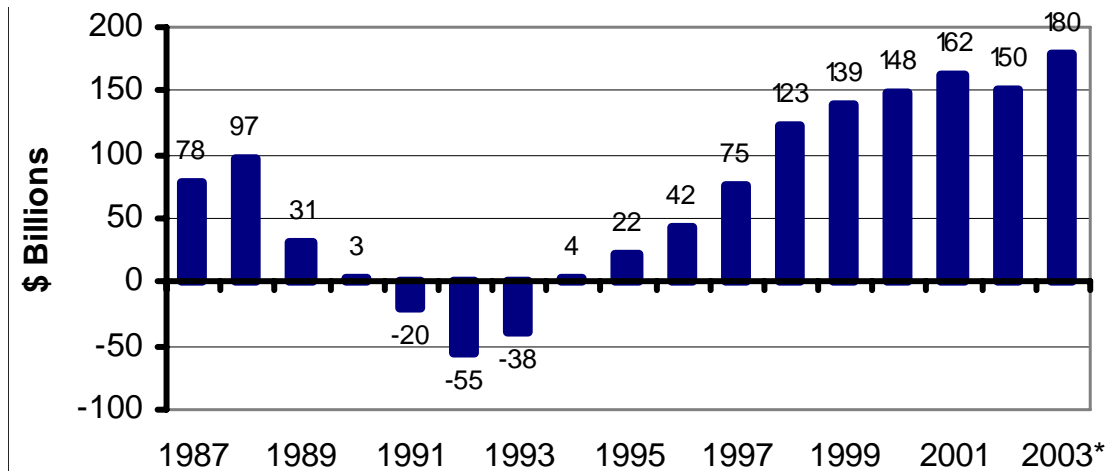
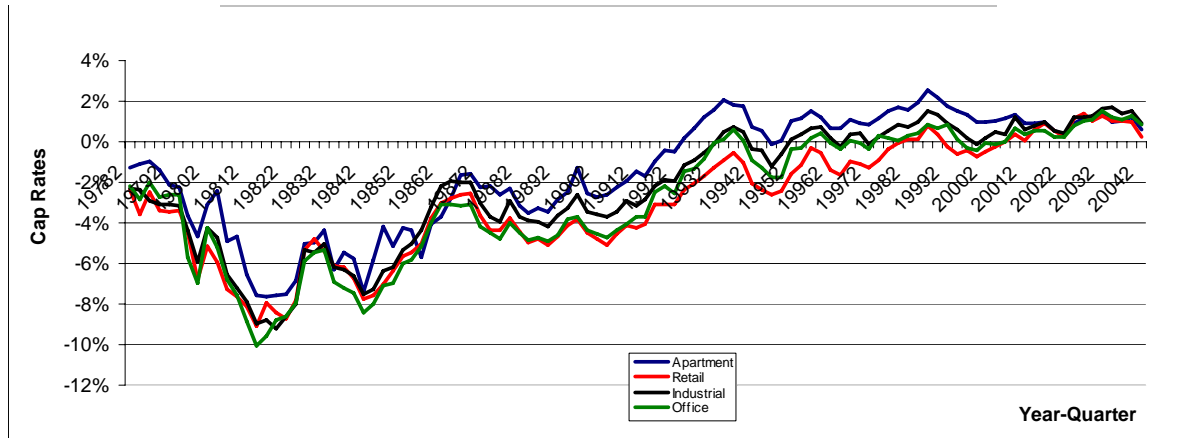
Valuation

NOI next year	$\$3 \text{ MM} * 1.01 = \mathbf{\$3.03 \text{ MM}}$
With Multiple and growth	$3.03 * 21.7 = \mathbf{\$65.8 \text{ MM}}$
With Multiple and no growth	$3 * 17.9 = \mathbf{\$53.7 \text{ MM}}$

Market Today

Description	Cap Rate
Office: Downtown office, prime towers, well located, well designed, top of the market, big building, lots of quality tenants, smooth lease expiration	7-8
Office: Suburban, good, smaller, fewer tenants, not as well located, not quite as liquid.	7.5-9
Office: Second tier city, suburban, small, two tenants, medium quality credit tenants, less liquid, lumpy lease expiration Comment: There is a large spread on the second tier office buildings. The city in which the property is located will have a significant impact on the property's cap rate.	8.5-12
Garden Apartments (A quality): Good location, recent design, (less visibility because no individuals will have credit, but the group does– these are individuals not companies occupying)	7-8
Garden Apartments (B quality): Usually has a good market	8-9.5
Garden Apartments (C quality): Usually has a good market Comment: There is a significant increase in the cap rate for lower quality, B and C, properties.	9-12
Shopping Centers (A): Good supermarket anchored tenant with Wal-Mart already in the competing market, so no fear of sudden entry and decline in customers	7.5-8.5
Shopping Centers (B): Pretty good strip center	8.5-11
Shopping Centers (C): Empty Kmart, not well located	10-14
Warehouse: Great location, near a major highway or exit ramp that leads to the property with ease.	8-9.5
Warehouse: Poor location, no easy access to the highway	9-12
Hotels: Hotels are incredibly difficult to value in this market.	n/a

A Look at the Past



Source: Federal Reserve Bank; *Mid year seasonally adjusted annual rate