



How to Estimate Resale Value Using "Cap" Rates

By Frank Gallinelli

Why do you invest in income-producing real estate? Perhaps you are looking for cash flow. Possibly you anticipate some tax benefits. Almost certainly, you expect to realize a capital gain, selling the property at some future time for a profit.

Your projection of the future worth of the property, therefore, can be a vital element in your investment decision.

Appreciation

A fairly simple approach to this issue is the use of an appreciation rate. You bought the property today for X dollars. You make a conservative estimate as to the rate of appreciation, apply that rate to your original cost and improvements and come up with presumed future value.

The use of appreciation as a predictor of future value typically makes sense when the desirability of the subject property is based on something other than its rental income. For example, consider a single-user property such as a small retail building on a main thoroughfare. The owner of a business operating as a tenant in such a location is probably willing to spend more for the building than an investor would pay. In general, rate of appreciation as a predictor of future value may be appropriate when comparable sales work well as a measure of present value (i.e., "Commercial buildings on Main Street are selling for \$200 per square foot by next year they will be up to \$225.").

Capitalization

With most other types of income-producing real estate, what you paid for the property is not likely to make much of an impression on a new buyer. Witness the rapid run-up and even faster collapse of prices in the late '80s. The typical investor will be interested in the income that the property can generate now and into the future. He or she is not buying a building so much as an income stream.

That investor is most likely to use capitalization of income as the method of estimating value. You have probably heard this referred to as a "Cap Rate" method. It assumes that an investment property's value bears a direct relation to the property's ability to throw off net income.

Mathematically, a property's simple capitalization rate is the ratio between its net operating income (NOI) and its present value:

$$\text{Cap. Rate} = \text{NOI} / \text{Present Value}$$

Net operating income is the gross scheduled income less vacancy and credit loss and less operating expenses. Mortgage payments and depreciation are not considered operating expenses, so the NOI is essentially the net income that you might realize if you bought the property for all cash. If you purchase a property for \$100,000 and have a NOI of \$10,000, then your simple capitalization rate is 10%.

To use capitalization to predict value requires just a transposition of the formula:

$$\text{Present Value} = \text{NOI} / \text{Cap. Rate}$$

The projected value in any given year (i.e., the "present value" in that year) is equal to the expected NOI divided by the investor's required capitalization rate.

To use capitalization rate as a predictor of future value, in short, is to use this logic: "I am buying this property with the expectation that its net operating income will represent a return on my investment. It is reasonable to assume that whoever buys the property from me in the future will have a similar expectation. That new investor will probably be willing to purchase the property at a price that allows it to yield his or her desired rate of return (i.e., capitalization rate)."

If you project that the property will yield a NOI of \$27,000, and that a new buyer will require a 9% rate of return (capitalization rate), then you will estimate a resale price of \$300,000.



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You must never forget that, while the algebra involved here is simple, the judgments you need to make in order to achieve an accurate prediction of value are more complex. Your assumptions as to future years' income and expenses have to be realistic.

The same is true of your estimate of a new buyer's required cap rate. Look at the investment from the new buyer's point of view and remember that there are other opportunities competing for his dollar. Would you buy an office building with a projected cap rate of 9% if you could buy a bond that yields 8%? What if mutual funds are rocking and rolling at 15% and more? To attract a buyer, your property may need to be priced so that its cap rate is competitive. The higher the cap rate, the lower the price. In our example above, the property with the \$27,000 NOI capitalized at 12% would be worth only \$225,000.

Our discussion here has been limited to simple capitalization rates. If you would like to delve deeper into this topic (for example, mortgage-equity cap rates), an appraiser's text on income-property valuation should be your next step.