

Cap Rates

The **Capitalization Rate** is a rate of return widely used in real estate investment to calculate the value of a property. It can be thought of as the annual yield an investor expects to get. If the annual income from a property is known- typically the annual rent minus the annual expenses- then the property value is calculated as:

Property Value = Annual Net Income / Cap Rate

For example, if the annual income is \$30,000 and the cap rate is 7 percent, then the value of a property is $\$30,000 / .07 = \$428,000$.

Putting a value on a property in this simple way ignores future changes to income or to property values. And the actual yield an investor gets can be much higher than the cap rate, because of the leverage provided by a mortgage.

Because of the difficulty of forecasting rents, expenses, and future values in real estate make the cap rate is a **handy alternative** for estimating the price an investor should pay.

1. Where can you find cap rates?

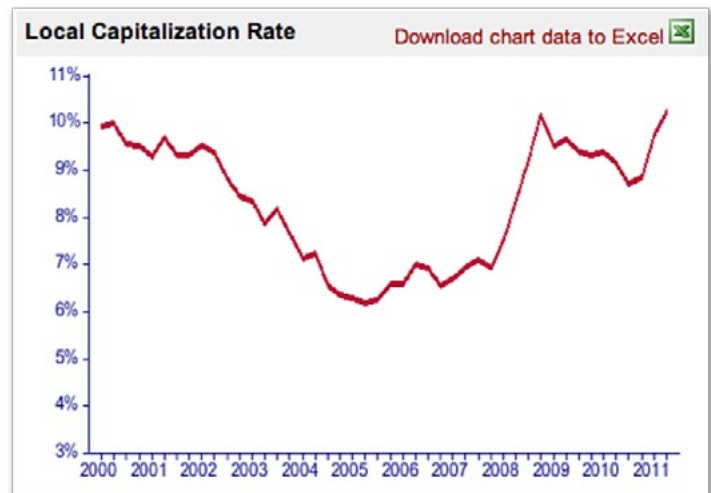
Unlike yields on stocks, bonds and other types of investments, cap rates are usually not published. Even if they were, they might not be the right ones to use.

Brokers may inform an investor about the cap rates used in recent transactions, in the same way realtors look at "comparable" sales when pricing a home. But bad investment decisions are made all the time and the cap rates from recent transactions may not be right for your investment.

Local Market Monitor believes that **transaction cap rates often do not reflect the actual risk of investing**; we therefore calculate and publish our own Local Cap Rates.

This is done by first determining the **financial cap rate** that relates to other interest rates, such as mortgage rates and the yields on BAA bonds, including a premium for the risk of higher vacancies when the economy is slowing down.

In addition, for each of 315 local markets we calculate a **local risk premium** that is added to the financial cap rate to get the local cap rate for that market.



Financial Cap Rate + Local Risk Premium = Local Cap Rate

For many local markets the risk premium is zero, in which case the local investment cap rate equals the financial cap rate; in some markets it can even be negative, if very high home prices make rentals less risky.

2. What does the Local Risk Premium measure?

The Local Risk Premium has two components that may appear at different points of the real estate cycle. One is the risk that low current home prices will pull rents down. The other is the risk that high current home prices will eventually fall.

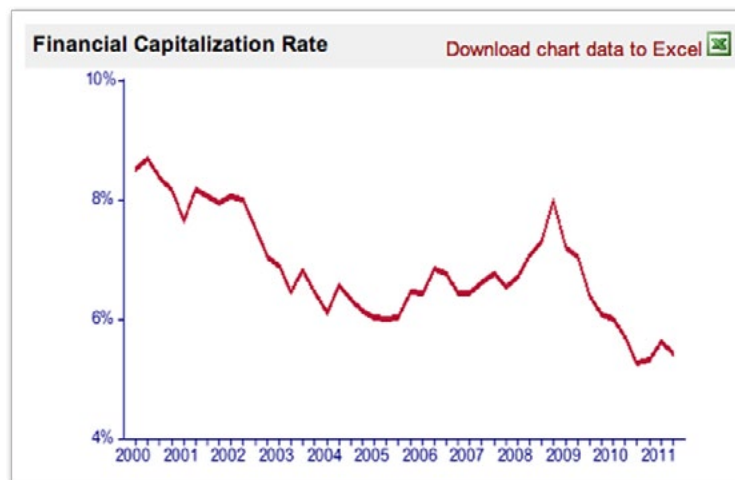
We calculate the first risk by comparing current home prices and rents. When rents are high relative to home prices, rents or occupancy rates are likely to fall. [Or, if local housing demand strengthens, prices may rise: the risk is also an opportunity.]

Local Market Monitor calculates the second risk by comparing current home prices with the Equilibrium Home Price for that market. When home prices are well above the Equilibrium Home Price, the likelihood of a future fall in prices increases sharply.

3. How quickly can Cap Rates change?

The Financial Cap Rate usually changes no more than 1 percent from year to year; since 2000 it been between 5 and 8 percent. Local Cap Rates can change more rapidly as home prices change; in Las Vegas from 8 percent in 2003 to 12 percent in 2006, for example.

Local Market Monitor recalculates Local Investment Cap Rates every quarter, when new home price information becomes available.



References:

Cap Rates and Real Estate Value Cycles
Lisa Glass and Jim Clayton
Babson Capital Research Note, June 2009

A Cross Sectional Analysis of Cap Rates by MSA
Chichernea, Miller, Fisher, Sklarz and White
Journal of Real Estate Research, 2008

Determinants of Appraisal-Based Capitalization Rates
Sivitanides, Southard, Torto and Wheaton
Torto Wheaton Research, March 2001

Cap Rates and Commercial Property Prices
Hobijn, Krainer and Lang
Federal Reserve Bank of San Francisco Economic Letter,
September 2011

Factors Influencing Capitalization Rates
Brent Ambrose and Hugh Nourse
Journal of Real Estate Research, Spring 1993