

CAP RATES

A cap rate is nothing more than an investor's return on his money if he bought a property for all cash. It is defined as follows:

$$\text{Cap Rate} = \frac{\text{Net Operating Income}}{\text{Purchase Price}}$$

In arriving at the property's net operating income (NOI), be sure to include a factor for *Vacancy and Collection Loss*, a Replacement Reserve, an Offsite Management factor, and if the property is management intensive, an Onsite Management factor. Remember, investors value properties from the point of view of a passive investor, not as an active manager of the property.

The return investors are willing to accept is reflective of what alternative investments are available in the market and at what risk. Cap rates have varied over the years and are usually lower when the economy is good and rise during a recession when real estate is down. Cap rates also vary in different regions of the country depending on supply and demand.

Below are some typical cap rates on typical properties in typical markets:

Property Type	Typical Cap Rates
Office	7.00% - 9.00%
Retail	6.50% - 8.50%
Concrete-Tilt Industrial building	7.50% - 9.00%
Steel Industrial building	8.00% - 9.50%
Motels & Hotels	9.00% -11.00%
Office and Industrial condos	6.00% - 8.00%
Small office buildings & converted	6.00% - 7.75%
SFR's	
Apartments	5.00% - 7.00%

Please note the extremely low cap rates on office condos, industrial condos, small free-standing office buildings and houses converted to cute little office buildings. The reason why the cap rates on such properties are so low is because they are being purchased by owner-users, not as rentals. Owner-users will pay a huge premium for small commercial properties because they seek the pleasure of owning their own building.

The prices per square foot commanded by office condos, industrial condos and tiny office or industrial properties cannot be justified economically. However, just as people everyday buy red corvettes for \$55,000 - even though they immediately drop to \$38,000 in value the minute the new owners drive the corvette off the lot - so will small business owners overpay for a property for their businesses. I call this the "Red Corvette Theory." People just want to own red corvettes.

Small apartment buildings (5-12 units) also often sell at ridiculously low cap rates below: 5.0%. The reason why is because lots of people want to get started owning apartment buildings, but they can only afford to buy *small* buildings. Therefore the price of the small buildings get bid up in price out of proportion to their income-generating ability.

It is often difficult to finance small income properties with institutional lenders because they seldom cash flow at greater than 55-65% loan-to-value. The purchases of office and industrial condos are usually financed by the S.B.A.