Real Estate Brokers, Investors Agree: Cap Rate's Subjectivity Demands More Metrics

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Although the capitalization rate is helpful in comparing the relative value of one property to another, a cap rate doesn't tell an investor the whole story. "Cap rates can be confusing because it depends upon what you use to calculate them," said Bob Anna, Broker Associate for BARBERMURPHY, the largest commercial real estate firm in Southern Illinois. "If you're basing your decision solely on a cap rate to cap rate comparison, especially during these unusual times, you'll be making a decision based upon income that might not reflect what the market is going to be."

By definition, a cap rate is based on a projection of the following 12-month, pro forma net operating income, according to Anna. Advertised cap rates, however, are often based on prior year or trailing 12-month actual net operating income, he noted. "More importantly, cap rates do not account for differences in financing, whether the leverage is positive or negative," Anna said, "or for future rent bumps, future changes in the tax assessment, reversionary property value at the end of the holding period and other factors. A property with a relatively low cap rate could still offer an exceptional return on investment over the holding period of the asset."

Investor Raj Tut, Founder and Principal of Gateway Multifamily Group, has acquired, transformed and managed more than $55 million in multifamily real estate over the past eight years. A benefit of Tut's focus on 40-unit to 100-unit class A and class B apartment developments is that his firm performs its own in-house financial modeling, pro forma and cap rate for each potential deal. "It allows us to determine whether we want to do a deeper dive in considering the investment," Tut said. "A cap rate is really only giving you a picture of what the deal looks like today, not in the future. We look at a potential real estate investment with a holistic approach, asking 'What can we do with this property once we acquire it? What's the neighborhood going to look like tomorrow?' Depending on these factors and others, we will determine what kind of spread we want between interest rates and the cap rate."

DBRS Morningstar Vice President and real estate analyst Kevin Augustyn says the direct capitalization method often works well when an investor is considering an established building that is substantially leased – one with a predictable income stream or a building that is in a market where there's a lot of activity and leasing, which could give a clear indication of what associated revenues and expenses may be. "But if you're looking at an older building that's about to undergo a major transformation such as a gut renovation or re-tenanting, or if the market is in flux, this method isn't going to tell you all you need to know," Augustyn said. "An alternate approach, such as a discounted cash flow value, allows you to finetune what will happen over the next one to two years until the property stabilizes." Factors such as the expected growth of the cash flow, projected building improvement, leasing costs and estimated operating expenses will likely also prove relevant in the analysis of the property over the next 12 to 24 months, according to Augustyn.

“Using a hospitality property as an example, the amount of work it will take to get the hotel up and running, such as hiring staff, ensuring the reservation system is up and running to accommodate guests, is relatively low as juxtaposed with a retail development where you may have lost a number of tenants and need to incur leasing commission, tenant improvement costs and time to build out or renovate the new space. A cap rate is not going to give you the ability to finetune your true cashflow needs over a decent period of time,” he added.

If the building and the market are undergoing a transition, Anna said, pegging the true value of the deal will require more and better metrics than the cap rate alone. “It’s critical for investors to seek out the expertise of a real estate broker who knows the local market, the properties and precisely how to properly value them,” said Anna. “Net present value, capital accumulation and other critical factors weigh into an intelligent decision. It’s more complex than just looking at the cap rate.”

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