

Investment Properties: A Primer

CHIP Board member James Wacht of Sierra Realty Corporation uses this primer to brief new staff members and to assist existing ones in keeping their knowledge current. He offered to share this with our members, an opportunity we happily took.

There are several methods by which to measure the value of an investment property. These methods are used by both sellers and buyers to determine an appropriate purchase price. To understand a market you need to review recent transactions and set-ups to see what “cap rates”, “multiples” and “prices per sq. ft.” properties are being sold for.

1. Cap Rate: Determine the capitalization rate (“cap rate”). A cap rate is the rate of return, expressed as a percentage that an investor expects to realize on his cash investment. It is applied to the net operating income (“NOI”) of the building to determine a value. This should be done both before and after any mortgage debt service. For example: assume a property with a NOI before debt service of \$100,000. If similar properties are being sold at a 6% cap rate then the subject property would have a value of \$1,666,667 (\$100,000 divided by 6%). Note, the lower the cap rate the higher the valuation. It is important to understand that cap rates can vary from building to building. Some factors that affect cap rates include:

- a. Risk:** The higher the risk, the higher the capitalization rate should be.
- b. Interest Rates:** As interest rates go up capitalization rates increase. This compensates for the higher cost of money. While this is a general rule, it isn't necessarily always true. Sometimes the increase in interest rates is simply reflected in the after debt service NOI. Because the increase in interest rates will result in an increase in debt service (i.e. the amount being paid on a mortgage), the after debt service NOI will be lower. The result is that the property will have a lower value even with the same cap rate being applied.
- c. Appreciation Potential:** If a building has significant upside potential, the cap rate may be lower. Thus a building with rents that are significantly below market will usually sell for a lower cap rate than a building with rents at or higher than market rents. Likewise a building with market or above market rents may sell at a higher cap rate.

- d. Demand:** Cap rates are affected by demand. The greater the demand for properties, the lower the cap rates.
- e. Alternative Investments:** Cap rates for real estate are also affected by rates of return on alternate investments. If an investor can achieve a high rate of return elsewhere, then they will expect a higher rate of return on real estate investments.

2. Multiple of Rent Roll: This only applies to residential properties and is the easiest calculation. This is simply the purchase price expressed as a multiple of the gross rent roll (“GRM”). For instance, if the property has a \$200,000 rent roll and is selling for \$2,000,000 then the GRM is 10. The same factors that affect cap rates also affect multiples. One very important factor that affects the multiple is the average rents for the apartments. If the average rents are low, the property will sell for a higher multiple because the property has greater upside potential.

3. Price per Square Foot: Determine the price per square foot. This is known as the price of the “bricks and mortar”. It is the amount per square foot for which the building is being sold. This is calculated by dividing the purchase price by the square footage of the building. If the building has excess air rights, a second calculation should be performed for the price per “buildable square foot”. This is calculated by dividing the purchase price by the total buildable square feet available at the property. For instance, if the purchase price of the building is \$1,000,000, and the building as constructed contains 10,000 square feet but an additional 10,000 square feet can be built, then the price per existing square foot is \$100 per square foot (i.e. \$1mm divided by 10,000) and the price per buildable square foot is \$50 per square foot (i.e. \$1mm divided by 20,000). The buildable square foot calculation is particularly important when discussing potential development sites.

4. Price per Unit: Calculate the price per unit and price per room. This is a much less important measurement than the others described above but it is a useful measure of value. It is particularly important in analyzing the conversion potential of a rental building.

Other measurements of value are also used including replacement cost, comparables and Internal Rates of Return (IRR). The IRR calculation is used for more complex transactions and requires preparing a cash flow projection over an extended period of time (usually 10 years plus) and introduces the timing of receipts and expenditures and an ultimate sales price into the formula. ■