PUTTING ON A CAP

by Steve Brown

Ask most bank lenders and they will tell you one of the best ways to monitor credit risk in a real estate loan portfolio is to keep tabs on the "Capitalization" (or "Cap") Rate ("CR"). For readers who are not CRE lenders, understand that the Cap Rate is best described as a ratio lenders, appraisers and investors use to estimate the value of income producing properties. Put another way, the CR is the rate at which a given property would pay for itself if you paid all cash for it.

For example, assume you find an apartment complex you want to buy for $1,000,000. Next, we assume the property has net operating income ("NOI") of $70k a year. To determine the Cap Rate, you take the net operating income and divide it by the purchase price (or market value). So, in this example, the Cap Rate is calculated as $70k divided by $1mm, or 7%. Note that the Cap Rate can be refined further by including a property's selling price, gross rents, non-rental income, vacancy amounts and operating expenses.

As investors wander around cities looking to buy property, they often have the Cap Rate as a compliment to risk. The lower the Cap Rate, the more stable the income growth should be. However, Cap Rates can be quite different when comparing different buildings. This is because one building might be in a single tenant rural warehouse, while another, a diversified, office building in a growing metro area. These and other factors can shift the Cap Rate for the investor, as the risk profile of the property changes. For instance, most investors would probably accept a lower Cap Rate in newer or more desirable areas and demand a higher Cap Rate rates in less desirable areas. This all sounds good, but if you have been a reader for more than a day of this publication, you also know it sounds too simplistic.

To understand the Cap Rate, we also have to intimately understand ("NOI"). NOI captures all of the income produced by a given property and subtracts out all of the expenses required to operate that property. For an apartment, income might be rents, while operating expenses could include property taxes, insurance, utility bills, repairs, maintenance, property management fees, employee payroll, etc.

The problem with the Cap Rate is in its very simplicity. The rate attempts to compare one building (for example) to other buildings in the same market. If the Cap Rate is higher, then maybe this building is a great deal, or maybe it has significant problems. Judgment is critical when calculating and comparing Cap Rates, so wise investors are also wary ones. In short, the Cap Rate is merely a high-level reflection of potential risk, gain, effort, or desirability of a particular area.

By definition, other problems with the Cap Rate occur because it rarely captures factors such as a property's physical condition, location, tenant quality and management. In addition, if a "like" building in this example hasn't sold recently, a comparative Cap Rate cannot be calculated because there is no sales price for comparison. Cap Rates have many more flaws and we'll cover them in a future edition. For now, however, ponder the extra layers of difficulty that erode the value of calculating Cap Rates when interest rates begin to move around, anchor tenants leave and other investment opportunities arise.

After all, nothing in this world is simple, so why should Cap Rates be easy?

BANK NEWS

Economists

Several major economists are coming out with their revised forecasts this morning. Of note, several are calling for another 50bp Fed Funds rate cut in March.

OCC

The regulator said that it will formally announce its first fee rate cut in more than 10Ys (since 1996). One aspect is that fee collections have been running 1% to 3% ahead of budget for the past several years, so the OCC feels that it is appropriate to make an adjustment.

Rebate Scam

Congress hasn't even passed the stimulus package and already con artists are posing as the IRS in an attempt to get personal and bank account data in order to process their "rebate."

Help

According to a new FHLMC survey, 57% of delinquent home borrowers are unaware of workout options and would like financial advisory assistance.