VALUATION / CAPITALIZATION

A significant use of the Net Operating Income (NOI) is in establishing the value of a property. Appraisers use three approaches to valuing real estate: replacement cost, market comparisons, and the income approach. When they appraise income property, all three methods are utilized, but appraisers emphasize the income approach in most cases.

To use the income approach to valuation, the NOI is converted into a value by use of a method called "capitalization." The calculation used to arrive at a value from the NOI is exceedingly simple. You take a percentage, referred to as a capitalization rate ("cap rate") and divide it into the NOI. The higher the cap rate, the lower the value. An easy way to think of it is to consider the NOI as an income stream. What would you be willing to pay for that income stream? Let's say that you want to make 10 percent on your investment. You are willing to pay a price whereby the NOI (a known amount) represents a 10 percent return on your investment. To calculate the price, you divide the NOI by .10; the answer is the price that you would be willing to pay.

Essentially the cap rate looks at the actual income and expenses of a particular building (without any mortgage expense which varies with each investor) and is the return that you would achieve if you paid all cash for a building.

The problem, as any appraiser will tell you, is figuring out what cap rate to use. Most income property, on a national level, used to be valued using cap rates between 8 and 12 percent. Appraisers will survey the market to see what the cap rates have been on recent sales. Lenders also keep track of what cap rates are being used to determine values of certain types of properties in different markets. A 10 percent cap rate was often used in the past, I think, partially because you can do the math in your head.

Unfortunately, the Seattle area has not seen cap rates this high in years. Cap rates are a function of supply and demand; in-city properties have been selling at cap rates of 4.5 to 6.0 (and even less in highly desirable areas like Queen Anne and Madison Park). As you move further north (Lynnwood to Everett) and south (Renton to Tacoma) the cap rates increase to the 6.5 to 8.5 range (and even higher in the more problematic rental areas) depending on the desirability of the property. This is the old "I wouldn't want to live there syndrome." Appreciation has also tended to be higher in the more popular neighborhoods. Apartment cap rates tend to be lower than office/retail properties since more people understand these investments and want to buy them. The vacancy risks are also lower (since an apartment vacancy can usually be filled in a comparatively short time by adjusting the rental amount or offering incentives) so owner/users are willing to pay more for apartment properties.

The current low interest rates (by historic standards) and the lack of supply are driving a seller's market allowing sellers to get their asking prices or more. Also, investors in 1031 tax deferred exchanges have only 45 days to identify a replacement property (or else get hit with the possibility of a hefty capital gains tax) which has allowed desirable apartment buildings to be "bid up."

Since more than half of the population of Seattle rents their home (which is a high percentage for an American city) investors have been willing to accept higher prices and lower cap rates as they look to hold their building for long term gain. Investors have always been bullish that the Puget Sound area is a good long term place for their investment dollars. The apartment buying frenzy of the past few years has abated somewhat but the supply of good properties still exceeds the demand with the long term outlook for multi-family investment in this region considered to be among the best in the nation. Steady rental increases have borne out their optimism as in-city vacancy rates have now dropped below 4% and we have reverted back to a landlord's market.

So when you are looking at a property that is for sale, you know the NOI and the asking price. By dividing the NOI by the asking price, you get the cap rate, which immediately gives you a general idea of whether the pricing is aggressive or conservative. As you work through a pro forma on an investment property, you may set a minimum or maximum cap rate that you will accept. Since cap rates are rather arbitrary, it is probably better to analyze the property to see if there are mitigating factors that can be taken into account to make the cap rate more acceptable (i.e. add stacked washer and dryers to each unit to increase rent, sub-meter the water to each unit to decrease expenses etc.)

Note that it is important to compare "apples to apples." Many listings do not include the same vacancy and expense information and many times the expense information is incomplete which will increase the NOI and therefore the value of the property. All buildings being considered should have similar vacancy rates and have complete expense information (real estate tax, insurance, repairs and maintenance, utilities reserves, management fees etc.). Sometimes it is easier, for comparison purposes, to just take 60-70 percent of the stated gross income (depending on age of the building) and use that as the NOI. Once an offer is accepted on a building, the buyer will get the actual books and records to confirm the numbers.

Assuming a stated NOI of $48,000 for a building, here are different values for the property, the only variable being the chosen cap rate.

CAP RATE		VALUE
5.0%	(48,000 / .050)	$ 960,000
5.5%	(48,000 / .055)	$ 872,727
6.5%	(48,000 / .065)	$ 738,461
7.5%	(48,000 / .075)	$ 640,000
8.0%	(48,000 / .080)	$ 600,000

As you can see, the cap rate doesn't have to change much to have a big impact on value. In the range of cap rates that we used (5.0 to 8.0), the difference in value from top to bottom is $360,000. Selecting a cap rate for your pro forma is a very subjective decision. Are you willing to pay the premium to have pride of ownership in a building located in a "hot" neighborhood or would you rather have steady cash flow in a building outside the Seattle city limits? More intensive management will probably be required for buildings with higher cap rates in more marginal areas but both types of buildings can be decent long-term investments depending on future rent increases and property appreciation.