

What Is The Investment Worth

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White Paper on Capitalization Rates

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How do you determine if the investment, whether it is a real estate investment or business opportunity, is right for your portfolio? Is there a way to determine or calculate the maximum amount you should pay for an investment and still achieve your investment goals? What is your desired return on the investment?

Let me introduce the infamous “CAP” Rate. The CAP Rate (Capitalization Rate) is one of the most misused acronyms propagating investment calculations. While many investors claim to use the cap rate to determine the value of the investment, it is more commonly misused to make assumptions about value.

Many brokers and lenders will take an investment’s net operating income and divide it by the “asking price” and out pops the Cap Rate. However, this method only tells us what the projected return will be in one year using an “all cash” investment. How many people actually use all cash to purchase investments? The method described does not take into consideration the various financing terms available to an investor at any particular moment in time. If we are truly going to use the CAP Rate to determine value we must first calculate our debt service and equity requirements.

Investors need not worry about what brokers, appraiser, and other investors value a particular investment. One certainly cannot rely on market assumptions about CAP Rates. There are too many variables to consider forecasting “market CAP rates”. How confident can you be that other investment sales were calculated with the appropriate “Net Operating Income” before determining the CAP Rate? We are not privy to their financial statements nor are they a matter of public records. Besides, it is doubtful the parties involved will open their statements to such scrutiny anyway.

Therefore, we need to just concentrate on what really matters and that is the value which allows you to attain your investment goals. In order to do this we need to calculate our particular debt service requirements for the type of investment and what return is desired on our investment in equity.

There are three items related to financing which should be ascertained for the investment. First, the Loan to Value ratio (LTV) for the investment, (This can fluctuate depending on the availability of money in the market) second, the loan term for the investment, and third, the interest rate offered to you. (Can depend on the relationship established with the financial institution) Once these items are obtained we can use them to calculate our debt service for the investment. The goal here is to establish the loan constant to be used. The loan constant is more than just the interest rate charged by the lending institution because it involves the loan term, and the interest rate. If one just used the annual interest rate the calculations will be skewed because this rate does not take into account amortization of the loan over its life or amortized life.

Annual Debt Service/Loan Principal Amount=Loan Constant

For instance, say the bank will make an acquisition loan two points above prime and the loan term is twenty years with a LTV ratio of 75%. Then, if the prime rate is currently 8.25%, the interest rate used in the calculation is 10.25%. For example, with a loan of \$350,000.00 the mortgage constant will be:

$$\begin{aligned} 3,435.75 \times 12 \text{ months} &= 41,229.02 \\ 41,229.02 / 350,000.00 &= .1178 \end{aligned}$$

The loan constant in this situation is .1178. (Note: This constant will be the same regardless of the loan amount because it is the loan term & interest rate which provides the variables)

The next item to consider is the return on your cash investment. (Cash on cash requirements) If the return you are seeking on your equity investment is 20% this will equate to an equity constant of .20. Of course, if you desire a higher return on your cash invested, you will need to adjust the equity constant accordingly. (It is common for many investors to expect a return somewhere between 15-35%)

The last step in determining your ideal CAP rate is to combine the weighted average of both the loan constant and the equity constant. It is weighted based on the LTV ratio each contributes. The debt ratio is 75% of the total sale and the equity ratio is the remaining 25%.

(LTV Debt Ratio x Loan Constant) + (LTV Equity Ratio x Equity Constant) = Derived CAP Rate.

$$.75 \times .1178 + .25 \times .20 = .1384 \text{ or } 13.84\% \text{ CAP Rate}$$

This CAP Rate becomes the investment CAP Rate desired to achieve your investment goal for this type of investment. Once this CAP Rate is determined, you can then use it to calculate the maximum sales price offer for the investment. Bear in mind, any other investment may require the use of a different CAP Rate--especially when it comes to financing. It may ultimately depend on the type of investment you are seeking.

If the net operating income (NOI) is \$125,000 then the maximum sales price you should expect is:

$$125,000 / .1384 = \$903,179.19$$

Once this price is determined you can use it to compare the actual sales price of the investment you are considering to decide if it will accommodate your objectives.

As you can see, this approach to CAP Rates is more involved than the typical CAP rates thrown around in the market. However, it is specifically tailored to your goals and objectives and will enhance the decision making process allowing you to quickly make decisions on the value of the investment as it relates to your portfolio.

Notes

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