**CAP RATES**

The**capitalization rate (also known as cap rate) is used in the world of commercial real estate to indicate the rate of return that is expected to be generated on a real estate investment property.**

**Capitalization Rate = Net Operating Income / Current Market Value**

Since cap rates are based on the projected estimates of the future income, they are subject to high variance. It then becomes important to understand what constitutes a good cap rate for an investment property.

The rate also indicates the duration of time it will take to recover the invested amount in a property. For instance, a property having a cap rate of 10% will take around 10 years to recover the investment.



Although capitalization rate can be a useful metric for properties that provide stable income, it is less reliable if a property has irregular or inconsistent cash flows.

Ex.

 **1 2 3**



|  |  |  |  |
| --- | --- | --- | --- |
| Property | Annual Income | Market value | Cap Rate |
| 1 | 100,000 | 1,000,000 | 10% |
| 2 | 150,000 | 2,500,000 | 6% |
| 3 | 275,000 | 4,000,000 | 6.88% |

The higher the cap rate the higher the risk because it will take longer to pay itself off. But these investments usually have more potential to produce higher profits, whereas lower cap rates are more secure investments. Buildings with higher cap rates can also be more volatile and the cap rates might be unreliable because cash flows cannot be estimated accurately for the future. Depending on your risk tolerance depends on what type of buildings you should look for.