



UNDERSTANDING CAP RATES

by John H. Gilliland

If you are planning to sell or purchase a self storage facility, your real estate broker will talk to you about values in terms of cap rates. If you are an owner looking to refinance a facility, your appraiser will use cap rates to determine a value. What exactly are cap rates, and how do we determine them? Why do we use cap rates in the first place? What cap rate is the current market using? This article will answer these questions and help you understand and use cap rates.

WHAT IS A CAP RATE?

Cap rate is short for capitalization rate. The definition of cap rate per the Third Edition of Dictionary of Real Estate Appraisal is "any rate used to convert income into value". Cap rates are a valuation tool used to compare returns on investment real estate that may vary in rent rates, construction, location, and a myriad of differences that typically occur between two properties. Cap rate also is an indication of what return an investor is seeking and is willing to pay when acquiring a self storage facility.

HOW TO DETERMINE CAP RATES

Cap rate is calculated by dividing the Net Operating Income (NOI) by the sale price.

$$\text{CAP RATE} = \frac{\text{NOI}}{\text{Sale price}} \text{ (expressed as a \%)}$$

So if you take your gross income generated by the property, subtract all normal operating expenses, excluding depreciation and loan payments, you get your NOI.

Divide this NOI by the sale price and you have a cap rate expressed as a percentage. Cap rate = NOI/Sale price.

$$\begin{aligned} &\text{Gross Income} \\ - &\text{Normal Operating Expenses} \\ &\text{(exclude depreciation \& loan payments)} \\ \hline = &\text{Net Operating Income} \end{aligned}$$

Conversely, you can determine a value by applying the appropriate cap rate to your NOI. The formula is:

$$\text{NOI} \\ \text{Cap Rate} = \text{Sale Price}$$

Just a note about calculating NOI. Investors and bankers are going to insist that the expenses you use to determine NOI are what a normal operator would experience. This includes monies for repairs, maintenance, lawn care and snow removal even though you may do some or all of these yourself, an off-site management fee in addition to what you pay your on-site manager, and a reserve fund for future capital expenditures.

- Operating Expenses include:**
- Property Taxes
 - Insurance
 - Payroll
 - Management Fees
 - Utilities
 - Advertising
 - Office Expense
 - Lawn Maintenance
 - Snow Removal
 - Repairs
 - Reserve fund for future Capital Expenditures

Let's look at an example. Say your facility has a gross income of \$550,000. Your operating expenses are \$175,000. Gross income less expenses equals a NOI of \$375,000. Let's say that your broker says that facilities of your size, condition and location are selling for 8.25% cap rates. To figure out the value of your property we

take the NOI divided by the Cap rate of 8.25% (cap rates are expressed as a fraction so divide by .0825).

Example:

\$550,000	Gross Income
- 175,000	Operating Expenses
\$375,000	NOI

**If cap rates in your area are
8.25% = .0825**

Then

\$375,000	
.0825	= \$4,545,454

$\$375,000 / .0825 = \$4,545,454$. The value estimate equals \$4,545,454.

Now let's say we are asking \$4,550,000 for your property. What cap rate would that sale price equal? Take your NOI and divide it by the sale price of \$4,550,000 and you get an 8.24% cap rate. Remember, the lower the cap rate the higher the value, conversely, the higher the cap rate the lower the value.

Lower cap rate = higher facility value

Higher cap rate = lower facility value

Let me explain it this way. If an investor paid all cash for a property and he paid an 8.25 cap rate, he is expecting that in the first year of ownership he will make 8.25% on the money he invested. (Most buyers don't pay all cash; they utilize bank loans and leverage their money, thus increasing their cash on cash returns to 9% to 11%).

WHY DO WE USE CAP RATES?

Now that we know the mechanics of cap rates, let's talk about why we use them.

First, self storage properties are valued primarily on their ability to produce income. Cap rates take this income and give it a value. This value, expressed as a cap rate, is based primarily upon the property's ability to produce a stream of income in the future, and the perceived risk of maintaining that income stream.

Second, because cap rates consider income only, it can be used to compare other alternate investments such as other real estate besides self storage, stocks, bonds and businesses.

Third, no two self storage properties are exactly alike. Brokers and appraisers need a method to compare properties with different locations, physical conditions, quality of construction and level of management. Cap rates are adjusted up or down depending on the level of risk of the property that it has in maintaining that future income stream.

Here are two extreme examples. The first is a rural property that is 15 years old with no on-site manager. The risk factors include a low population in the market area, the abundance of land that a competitor may build on, and finally the condition of the property after 15 years of use. This property may be valued at a 9.5% cap rate. The second example is a three-year old property located in a growing suburb built with a large office and showroom staffed with a full-time manager. The value may be 7.25% because of the growing population, new construction, professional management, and barriers of entry for competitors.

Factors which demand a higher cap rate (thus a lower value) are poor visibility, no management office, deferred maintenance, low occupancy, no security measures, declining population base, too much competition, and poor design of the facility. Factors that lower the cap rate (thus increasing the value) are excellent visibility and access from a major highway, newer construction, well-designed layout, security measures including cameras, gates and door alarms, professional management, clean grounds, high occupancy, and low delinquencies.

WHAT IS THE CURRENT MARKET CAP RATE?

Let me first say that that the cap rate used for a particular property is best determined by a professional real estate broker or appraiser that has lots of experience in self storage. They should be able to show you a minimum of 5 to 6 comparable properties with cap rates for you to compare.

That being said, the range in my experience for cap rates in the mid-Atlantic states range from a low of 7% for the best properties to a 9.25% for properties that are considered higher risk investments. Some portfolio sales have sold for less than 7 cap rates. The mean cap rate would be 8.4%.

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