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John Rynne - Estimating net operating income and cap rates can be similar to calling balls and strikes

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The most prevalent income approach method is direct capitalization which is based upon the premise that Value=Net Operating Income divided by an Overall Capitalization Rate (NOI/Cap Rate=Value). Net Operating Income is referred to as NOI and the overall capitalization rate is referred to as a "Cap Rate." This is a simple mathematical method with only two ingredients (NOI and Cap Rate) needed to find value. Estimating cap rates is like calling balls and strikes. Each umpire has different philosophies of where the strike zone is. Similarly, real estate valuers also have different philosophies when estimating NOI and Cap Rates.

As an example, if the NOI was $900,000 and the cap rate is 9%, the indicated value is $10 million ($900,000/9%). However, it's important to make sure that the NOI and Cap Rate is carefully chosen. If the cap rate was 10% instead of 9%, the value would be $9 million ($900,000/10%) instead of $10 million. This is a value difference of $1 million. If the stabilized NOI was decreased to $850,000 in conjunction with a 9% cap rate the value is $9,444,444 ($850,000/9%). A 10% cap rate would result in a value of $8.5 million ($850,000/10%). So for this simple exercise there are four values($8.5 million; $9 million; $9,444,444 and $10 million) which have a variance of $1.5 million. It's critical to establish a reliable NOI and Cap Rate. NOI is the potential gross income less vacancy and credit loss less operating expenses before debt service. A cap rate is a ratio of NOI and Value. If the NOI is $850,000 and the sales price is $9,444,444, the cap rate is 9% ($850,000/$9,444,444).

Appraisers and brokers sometimes have different interpretations of cap rates. It's important to be consistent with what the stabilized expense philosophy the broker or appraiser uses. As an example, most appraisers use significant management fees and reserves. Many brokers and some appraisers generally don't consider as much reserves and management. Therefore, the broker's interpretation of stabilized NOI for a property results in a higher cap rate than the appraiser. Appraisers also may have differing view points upon reserves and management. Reserves are similar to capital improvements which cannot be expensed in a single tax year. Instead, most of the capital improvements are capitalized based upon market guidelines. The reserves and capital improvements typically are short lived components such as HVAC, carpet, roofs, parking lots, etc. Most appraisers estimate reserves on some basis by tying it to economic life. I have observed some appraisers use no reserves for tenant improvements and commissions. In that case it is assumed that the funds for reserves will be put in as additional equity not taken out of cash flow. Some appraisers will assume that all is taken out of cash flow. My observation is that most appraisers assume reserves will represent a blend of both sides of the spectrum.

Management is another gray area especially for smaller income producing properties where there is no formal management contract or personnel. A "hands on" owner may not allocate any management expense. An appraiser who uses significant reserves and management generally will have lower overall cap rates since the expense ratio is increased with higher reserves and management if everything else is equal. Brokers, appraisers and other market participants who minimize reserves and management operate at a higher level of cap rates. As an example, a property sold for $10 million with effective gross income of $1.5 million and operating expenses of $700,000 without significant reserves and management considered. This results in a NOI of $800,000 ($1.5 million-$700,000) or an 8% cap rate ($800,000/$10 million). If the philosophy of the appraiser or broker is to use substantial reserves and management the expenses may be $750,000. Assuming the effective gross income is still $1.5 million, results in a NOI of $750,000. The indicated cap rate would be 7.5% ($750,000/$10 million). In fact, in the Rynne, Murphy & Associates, Inc. Real Estate Market Investment Rate Survey, there is a footnote which states "These rates assume that adequate management and reserve expenses are considered." In conclusion, estimating NOI and Cap Rates can be similar to calling balls and strikes.

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