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Newsletter

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Cap Rate Is Not the Total Investment Return

By David V. Tran

In most if not all commercial property listings, you always see the cap rate listed. Investors often use cap rate as one of the main selection criteria as it indicates the investment return. However, cap rate alone does not tell you the whole story about investment return.

Let's look at 2 properties: property #1 has 8% cap and property #2 with 7.25% cap:

- The first property is purchased for $3M. The lender provides a $2.1M loan (70% LTV) at 7.25% interest.
- The second property is also purchased for $3M. The lender provides a $2.1 loan (70% LTV) at 6.25% interest.

While property #1 offers higher cap rate than property #2, the return of equity for property #2 is almost the same as property #1. This is due to lower interest rate of 6.25%. Why does property #2 get lower interest rate? There are many factors that determine the interest rate:

	Property #1 $3M, 8% cap	Property #2 $3M, 7.25% cap
Net Operating Income	$240,000	$217,500
Loan amount	$2,100,000	$2,100,000
Down payment	$900,000	$900,000
Loan interest	7.25%	6.25%
Annual Interest payment	$152,250	$131,250
Income before tax	$87,750	$86,250
Investment equity return	9.75%	9.58%
Appreciation rate	1% per year	3% per year
Appreciation value	$30,000	$90,000
Total return	13.08%	19.58%

Loan amount: In residential mortgage if you borrow less money, i.e. a conforming loan, your interest rate will be the lowest. When you borrow more money, i.e. a jumbo or super jumbo loan, your rate will be higher. In commercial mortgage, the reverse is true! If you borrow $200K loan your rate could be 9%. But you borrow $3M, your rate could be only 5.9%! In a sense, it's like getting lower price when you buy an item in large volume at Costco.

Property type: the interest rate for a single tenant night club building will be higher than multi-tenant retail strip because the risk is higher. When the night club building is foreclosed, it's much harder to sell or rent it compared to the multi-tenant retail strip. The rate for apartment is lower than shopping strip. To the lender, everyone needs a roof over their head no matter what so the rate is lower for apartment.

Age of the property: loan for newer property will have lower rate than dilapidated one. To the lender the risk factor for older properties is higher so the rate is higher.

Area: if the property is located in a growing area like Atlanta metro the rate would be lower than a similar property located in the rural declining area of Arkansas. This is another reason you should study demographic data of the area before you buy the property.

Tenant: single-tenant property with a brand name/national tenant, e.g.

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Walgreens will get a lower interest than local tenant.

Location: the retail center next to Walmart will probably get a lower rate than a retail center shadow anchored by a local furniture store.

Your credit history: similarly to residential loan, if you have good credit history, your rate is lower.

The lenders you apply the loan with. Each lender has its own rates. There could be significant difference, e.g. over 1%, in the interest rate for the same property. If you apply for a commercial loan yourself, chances are you will pay a higher rate because you apply for the loan at the "wrong" lender. Commercial loans are very different from residential loans. So you should work with someone specialized on commercial loans to shop for the lowest rates.

Prepayment flexibility: If you want to have the flexibility to prepay the loan then you will have to pay higher rate. If you agree to keep the loan for the term of the loan, e.g. conduit loan, then the rate could be 1% lower.

Commercial properties also appreciate at different rates. When appreciation is factored into the return even at a conservative 3% rate, property #2 has almost 50% higher total return than property #1, 19.58% vs. 13.08%. The following are some of the factors that may influence the appreciation of a property:

- **Demographics**: in a growing area where more people are moving in than moving out then the appreciation is likely to be high. The more affluent area is likely to have higher appreciation than a low-income area.
- **Age**: A 40 year-old property is likely to appreciate slower than 3 year old center.
- **Rent**: if the current rent is $1.25/SF while the market rent is $2/SF, the property has upside potential when the lease is renewed. If the property has strong annual rent increase, e.g. 3-4%, the net income will be higher next year. Higher income will result to higher property value.
- **Location**: a property at a good location, e.g. just off freeway exit, is likely to get a better appreciation.
- **Demand and supply**: in a market where there are more buyers than sellers the appreciation should be higher.
- **Inflation**: construction materials cost more every year due to inflation and strong demand in developing countries. For example cement, lumber, steel, and copper cost more now due to strong demand from China. Labor costs also increase due to inflation. Fees for various construction permits also increase for various economic and political reasons. As a result, construction expenses go up.

So it's important to have an experienced broker who does business in various states and can provide you a big picture of the market.

Conclusion: You should evaluate the return of investment based on:

1. Cap rate the property offers,
2. Interest rate that you will pay for the loan and,
3. Potential appreciation the property will generate.

It's not a bad idea to have a broker with knowledge & experience about both commercial real estate and loan to represent you. Otherwise, you may end up screen out the very best properties.

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