HOW TO CALCULATE A CAP RATE

Capitalization Rate (or “cap rate”) is the ratio between the net operating income produced by an asset and its capital cost. The rate is calculated in a simple fashion as follows:

Cap rate = annual net operating income divided by Purchase price (or cost + reno)

As a general rule of thumb, it is the opinion of many investors that a cap rate of 20% or more is a very sound investment. With interest rates being at all time low levels, investing in income properties has become much more appealing. Today’s market trend of low prices and reasonably high rental rates is an excellent opportunity for investors looking in all price ranges.

For example, if a building is purchased for $1,000,000 sale price and it produces $100,000 in positive net operating income (the amount left over after fixed costs and variable costs are subtracted from gross lease income) during one year, then:

- $100,000 / $1,000,000 = 0.10 = 10%

The asset’s capitalization rate is ten percent; one-tenth of the building’s cost is paid by the year’s net proceeds. If the owner bought the building twenty years ago for $200,000 his cap rate is:

- $100,000 / $200,000 = 0.50 = 50%