



Capitalization Rates: *why they rule the market*

What is a cap rate and how is it calculated?

The capitalization (cap) rate, estimates the value of an income producing property. It is calculated as the net operating income from a property divided by the property's market price; given as a percentage. The net operating income is gross income minus operating expenses (not including debt service). Income and expenses must be verified in order to get a true net operating income (NOI). An investor looking to purchase an income producing property will seek the highest possible cap rate; whereas a seller will try to sell at the lowest possible cap rate in market conditions.

Why are cap rates lower in Central Oregon than in other parts of the state and country?

One contributing factor was the poor rate of return on traditional investments (i.e. stocks and bonds) and the dot.com bust of the '90s; which lead to many investors to move their funds out of stocks and bonds and into real estate. As this capital poured into investment properties during Central Oregon's economic highs, they consequently drove up the prices of such properties. The low interest rates and fluid capital in the local commercial real estate market helped create a downward trend in cap rates. Strong investor demands for properties have also pushed the valuations to a higher level. As cap rates in Central Oregon reached a near historic low and the Feds increased short term interest rates, investors grew concerned about the effects that higher interest rates had on asset values during the recovery phase. Cap rates and interest rates are typically closely related since the real estate industry is capital intensive and relies heavily on debt; meaning as interest rates increase, higher cap rates usually follow.

What factors contribute to the true value of an income producing property?

It is important to use the due diligence period effectively to analyze rent roll, maintenance history, lease types, tenant strength and area comps; justifying the cap rate and purchase price. These factors are correctable by a skilled professional property management team who schedule building maintenance, convert tenants to triple net (NNN) leases, and enforce annual escalators within the lease. NNN leases require the tenants to pay all insurance, maintenance, taxes, and normal utility expenses; leaving the owner free from daily management responsibilities. A professional property manager will also help the resale of your property substantially by maintaining and improving the building's value. Many factors can influence the true value of an income property. Important ones to look for are deferred maintenance, strength of the tenants and the length of the leases, comparable sales in the area, general economic and local market conditions. Locally, one issue in the forefront is ADA accessibility. We are finding that relatively new buildings are not up to code and could result in future costs to bring it up to code compliance should a tenant need a remodel or any new construction.

What can I currently expect from a local investment property?

As an investor, it is crucial to calculate a building's long-term cash flow. What might appear as a poor investment, could be a financial success in a short time with minor adjustments. A 6.25 - 6.75 percent cap rate property could be a great investment in the local market after evaluating all factors. Debt is usually fixed but rents will continue to increase, typically around 3% annually in the Central Oregon market. We have seen a steady increase in rental rates, especially for second generation space as leases come due. This is attributed to the increase cost of construction to replicate the already improved space. Increased new construction costs, land price, SDC fees and material costs impact the rental rate as well.



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