Capitalization Rate - Cap Rate

The Capitalization Rate or Cap Rate is a ratio used to estimate the value of income producing properties. Put simply, the cap rate is the net operating income divided by the sales price or value of a property expressed as a percentage. Investors, lenders and appraisers use the cap rate to estimate the purchase price for different types of income producing properties. A market cap rate is determined by evaluating the financial data of similar properties which have recently sold in a specific market. It provides a more reliable estimate of value than a market Gross Rent Multiplier since the cap rate calculation utilizes more of a property's financial detail. The GRM calculation only considers a property's selling price and gross rents. The Cap Rate calculation incorporates a property's selling price, gross rents, non rental income, vacancy amount and operating expenses thus providing a more reliable estimate of value.

$$\text{Cap Rate} = \frac{\text{NOI}}{\text{Value}} \qquad \text{Estimated Value} = \frac{\text{NOI}}{\text{Cap Rate}}$$

Cash on Cash Return

Cash on Cash Return is a percentage that measures the return on cash invested in an income producing property. It is calculated by dividing before-tax cash flow by the amount of cash invested and is expressed as a percentage.

$$\text{Cash on Cash Return} = \frac{\text{Pre-Tax Cash Flow}}{\text{Cash Invested}} \times 100$$

Debt Coverage Ratio

This is also known as Debt Service Coverage Ratio (DSCR). The debt coverage ratio is a widely used benchmark which measures an income producing property's ability to cover the monthly mortgage payments. The DCR is calculated by dividing the net operating income (NOI) by a property's annual debt service. Annual debt service equals the annual total of all interest and principal paid for all loans on a property. A debt coverage ratio of less than 1 indicates that the income generated by a property is insufficient to cover the mortgage payments and operating expenses. For example, a DCR of 0.9 indicates a negative income. There is only enough income available after paying operating expenses to pay 90% of the annual mortgage payments or debt service. A property with a DCR of 1.25 generates 1.25 times as much annual income as the annual debt service on the property.

$$\text{Debt Coverage Ratio} = \frac{\text{Net Operating Income}}{\text{Annual Debt Service}}$$

Gross Rent Multiplier - GRM

The Gross Rent Multiplier or GRM is a ratio that is used to estimate the value of income producing properties. The GRM provides a rough estimate of value. Only two pieces of financial information are required to calculate the Gross Rent Multiplier for a property, the sales price and the total gross rents possible. If this information is available for multiple sales of similar types of income properties in a particular area, it can then be used to estimate the market value of other similar properties in that area. Some investors use a monthly Gross Rent Multiplier and some use a Yearly GRM. The monthly Gross Rent Multiplier is equal to the Sales Price of a property divided by the potential monthly gross income and the Yearly GRM is the Sales Price divided by the yearly potential gross income.

The capitalization rate is a more reliable tool for estimating the value of income producing properties since vacancy amount and operating expenses are included in the cap rate calculation. The GRM is useful in providing a rough estimate of value.

Internal Rate of Return - IRR

The Internal Rate of Return or IRR calculation put simply measures the average annual yield on an investment. For an income producing property, the internal rate of return or IRR calculation uses the initial amount invested in the property, a series of projected cash flows which are usually after-taxes and a projected After-Tax Sales Proceeds amount in a given year.

If we were calculating the internal rate of return for an income producing property 5 years in the future, we would use the Initial Investment amount or the amount of money put down on the property, the projected After-Tax Cash Flows for each of the five future years and the anticipated After-Tax Sales Proceeds in year five, the final year, to calculate an average annual return on our initial investment amount over the five year period.

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