Capitalization Rate Guidance

March 2025

What is a Capitalization Rate?

A cap rate or an Overall Capitalization Rate (OAR) is used to convert the **expected** net operating income (NOI) into a present value.

A capitalization rate may be considered a combination of two rates of return:

1. A rate of return *on* capital
2. A rate of return *of* capital

The rate of return on capital is analogous to an interest rate. The rate of return of capital is analogous to the rate at which capital is recovered.[1]

Overall Capitalization Rates can be displayed as: Cap Rate, OAR and R_O

Capitalization is the conversion of income into value.

The universal formula for calculating value on the basis of a cap rate is:

$$\frac{\text{NOI}}{\text{OAR}} = \text{Value}\text{, expressed as I/R = V, or IRV}$$

A direct capitalization technique employs capitalization rates extracted from market data. Only the first year's income is explicitly considered.

Derivation of a Capitalization Rate

• Comparable sales • Published sources • Personal surveys and interviews with market participants	• Band of Investment model • Debt Coverage Ratio model

Historical References to the Importance of Overall Capitalization Rates

The topic of selecting the Overall Capitalization Rates has been an on-going analysis in the appraisal industry.

The Appraisal Journal, Selection of the Capitalization Rate by John White, A.B., M.B.A. October 1949[2]

"In the technique of real estate valuation, the selection of the capitalization rate is perhaps the most important single element. A high degree of skill and judgment may have been utilized to estimate the anticipated income and expense, analyze neighborhood trends and make a painstaking physical inspection

[1] Appraisal Institute, Capitalization Theory and Techniques Study Guide, Third Edition, 17
[2] Appraisal Institute, The Appraisal Journal, October 1949, 478

of the property; but none of these elements assumes the prominence which should be accorded the judicious and well documented selection of the proper capitalization rate. Yet little consideration has been given to a scientific analysis of the reasons for its selection." "It appears that undue emphasis has been placed on phases of the valuation process which require mechanical rather than intellectual ability…Judgment and experience play a major role in the process of rate selection…"

The Appraisal Journal, Capitalization Rates by James E. Gibbon, MAI (April 1959)[3]

"While all factors in the income approach to value are undeniably of great importance, the one element which appears to be the heart of the technique is the capitalization rate. For it is by such rate that a property's net income is processed into value and, as will be demonstrated, small changes in capitalization rates will produce wide variations in valuations. If, then, these rates are the point about which the income approach turns, it is appropriate to accord them very serious consideration."

The Appraisal Journal, Supporting Capitalization Rates by Gregory J. Accetta, MAI (October 1998)[4]

"Appraisers often fail to provide adequate support for capitalization rates because they either forget or ignore the basic premise of direct capitalization - that the OAR is derived from market transactions - and they treat the derivation of the OAR simply as a mechanical or mathematical procedure."

Capitalization Rate Analysis

Deriving OARs: "Appraisers sometimes overlook a current or pending sale of the subject property. Not only does this cause the appraiser to miss valuable market data, but it is also a violation of USPAP Standards Rule 1-5 (a). For example, if the property is leased, the net operating income and sale price can provide an excellent indication of an overall capitalization rate. Perhaps even a yield rate or equity rate indication can be derived from the data. Many appraisers consult nationwide rate surveys to support their rate derivation when one of the most credible rates is the one indicated by the sale of the subject property. Since the income capitalization approach is a forward-looking approach, an overall rate can also be developed using a sale price and the buyer's projected NOI (I_O)."[5]

"The direct capitalization method is often selected because it seems to obviate forecasting property income and expenses over an extended period. Because it is much easier to establish the market rent for a property today, the resulting value opinion might be assumed to be more accurate than one based on the property's future cash flows. Although the method does not require a forecast of future income and expenses, the overall rate includes assumptions about how the marketplace perceives that a property's income is expected to change over time. This fact is effectively hidden in plain sight within the capitalization rate - a single number. Direct capitalization appears to be a simplistic approach because the complicated mathematics underlying the overall rate can be easily disguised. [6]

[3] Appraisal Institute, The Appraisal Journal, April 1959, 175

[4] Appraisal Institute, The Appraisal Journal, October 1998, 372

[5] Appraisal Institute, Appraising the Appraisal, The Art of Appraisal Review, 2nd Edition, page 53

[6] Appraisal Institute, Appraising the Appraisal, The Art of Appraisal Review, 2nd Edition, page 70

Capitalization Rate Sensitivity:

Scenario 1

		%EGI
Rent	$2,400,000	
Other Income		
Miscellaneous	$25,000	
Parking	$15,000	
PGI	$2,440,000	
Vacancy	$122,000	5.00%
Effecti Gross Income	**$2,318,000**	
Expenses		
Real Estate Taxes	$225,000	9.7%
Insurance	$61,875	2.7%
All Utilities	$100,000	4.3%
Pest Control	$12,000	0.5%
Repairs & Maintenance	$80,000	3.5%
Turnover	$20,000	0.9%
Landscaping	$30,000	1.3%
Pool	$10,000	0.4%
Nonresidential Manager	$115,900	5.00%
Payroll	$50,000	2.2%
General & Admin.	$20,000	0.9%
Reserves	$30,000	1.3%
Total Expenses	**$754,775**	**32.6%**
Expenses Excluding Taxes		22.9%
NOI	$1,563,225	
OAR	5.00%	
	$31,264,500	
Rounded	**$31,300,000**	

30%

△ Value Scenario 1 and 3

Scenario 2

		%EGI
Rent	$2,400,000	
Other Income		
Miscellaneous	$25,000	
Parking	$15,000	
PGI	$2,440,000	
Vacancy	$122,000	5.00%
Effecti Gross Income	**$2,318,000**	
Expenses		
Real Estate Taxes	$225,000	9.7%
Insurance	$61,875	2.7%
All Utilities	$100,000	4.3%
Pest Control	$12,000	0.5%
Repairs & Maintenance	$80,000	3.5%
Turnover	$20,000	0.9%
Landscaping	$30,000	1.3%
Pool	$10,000	0.4%
Nonresidential Manager	$115,900	5.00%
Payroll	$50,000	2.2%
General & Admin.	$20,000	0.9%
Reserves	$30,000	1.3%
Total Expenses	**$754,775**	**32.6%**
Expenses Excluding Taxes		22.9%
NOI	$1,563,225	
OAR	5.75%	
	$27,186,522	
Rounded	**$27,200,000**	

-13%

△ Value Scenario 1 and 2

Scenario 3

		%EGI
Rent	$2,400,000	
Other Income		
Miscellaneous	$25,000	
Parking	$15,000	
PGI	$2,440,000	
Vacancy	$122,000	5.00%
Effecti Gross Income	**$2,318,000**	
Expenses		
Real Estate Taxes	$225,000	9.7%
Insurance	$61,875	2.7%
All Utilities	$100,000	4.3%
Pest Control	$12,000	0.5%
Repairs & Maintenance	$80,000	3.5%
Turnover	$20,000	0.9%
Landscaping	$30,000	1.3%
Pool	$10,000	0.4%
Nonresidential Manager	$115,900	5.00%
Payroll	$50,000	2.2%
General & Admin.	$20,000	0.9%
Reserves	$30,000	1.3%
Total Expenses	**$754,775**	**32.6%**
Expenses Excluding Taxes		22.9%
NOI	$1,563,225	
OAR	6.50%	
	$24,049,615	
Rounded	**$24,000,000**	

-23%

△ Value Scenario 3 and 1

USPAP Minimum Reporting Requirements for Supporting Conclusions

1. **It is a USPAP minimum reporting requirement (See Standards Rule 1-1(a))** [7]
   "In developing a real property appraisal, an appraiser must: be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal."

2. **Standards Rule 1-1(b)**[8] "An appraiser must not commit a substantial error of omission or commission that significantly affects an appraisal."

3. **Standards Rule 1-4**[9] "In developing a real property appraisal, an appraiser must collect, verify, and analyze all information necessary for credible assignment results."

   Standards Rule 1-4 (c)[10] "When an income approach is necessary for credible assignment results, an appraiser must:

   I. analyze such comparable rental data as are available and/or the potential earnings capacity of the property to estimate the gross income potential of the property;

   II. analyze such comparable operating expense data as are available to estimate the operating expenses of the property;

   III. analyze such comparable data as are available to estimate rates of capitalization and/or rates of discount; and

   IV. base projections of future rent and/or income potential and expenses on reasonably clear and appropriate evidence."

4. **Standards Rule 2-1(a) and (b)**[11] "clearly and accurately set forth the appraisal in a manner that will not be misleading; **(b)** contain sufficient information to enable the intended users of the appraisal to understand the report properly;"

5. **The objective of the appraisal report is to communicate the valuation process with sufficient supporting evidence and logic to ensure that the assignment results are credible for the intended use.**[12]

6. **Well-supported conclusions help the reader understand the selection process and reasoning.**

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[7] The Appraisal Foundation, Uniform Standards of Professional Appraisal Practice (USPAP) 2024 Edition (The Appraisal Foundation, 2024), 18

[8] The Appraisal Foundation, Uniform Standards of Professional Appraisal Practice (USPAP) 2024 Edition (The Appraisal Foundation, 2024), 18

[9] The Appraisal Foundation, Uniform Standards of Professional Appraisal Practice (USPAP) 2024 Edition (The Appraisal Foundation, 2024), 20

[10] The Appraisal Foundation, Uniform Standards of Professional Appraisal Practice (USPAP) 2024 Edition (The Appraisal Foundation, 2024), 20-21

[11] The Appraisal Foundation, Uniform Standards of Professional Appraisal Practice (USPAP) 2024 Edition (The Appraisal Foundation, 2024), 22

[12] Appraisal Institute, The Appraisal of Real Estate, 15th Edition, 37

7. **In the context of the quality of work being reviewed, adequacy means that the work satisfies the minimum requirements for its intended use.**[13]

   An appraisal described as "adequate" would not necessarily serve as a model of best practices, but it would meet minimum professional standards. An "inadequate" appraisal would not address how the capitalization rate was derived (pro forma vs. T-12).

8. **Another sign of potential incompleteness is a lack of explanation for the choice of a capitalization rate from within a given range. The absence of this explanation gives the appearance of an arbitrary decision on the appraiser's part, i.e., an unsupported conclusion. The lack of support for the capitalization rate used is particularly important because small variations in the rates used to capitalize income into indications of value have a significant effect on value and therefore the results of the appraisal.**[14]

9. **Evaluating reasonableness is not exclusive to appraisal. In many professions in which opinions are important, the quality of work is often judged by the *reasonableness* of the opinions presented. In a sense, reasonableness is the flip side of negligence.**[15]

Standards Rule 1-6, Reconciliation (*lines 627-629*):
In developing a real property appraisal, an appraiser must:

a) reconcile the quality and quantity of data available and analyzed within the approaches used; and

b) reconcile the applicability and relevance of the approaches, methods and techniques used to arrive at the value conclusion(s).[16]

Standards Rule 2-2(a)(x)(5) *(lines 694-695)***:**
"Summarizing the information analyzed and the reasoning that supports the analyses, opinions, and conclusions, including reconciliation of the data and approaches; opinions, and conclusions, including reconciliation of the data and approaches;"[17]

Appraisal Institute, The Appraisal of Real Estate, 15th Edition

Judgment
"All pertinent value influences, facts, and conclusions about trends should be clearly indicated in the report and related specifically to the property being appraised. Because the data selected forms the basis for the appraiser's judgments, a thorough explanation of the significance of the data reported ensures that the reader will understand these judgments."[18]

Anticipation
…"an appraiser should consider the future outlook both in estimating income and expenses and in selecting the appropriate capitalization methodology to use. The consideration of future income is consistent with the principle of anticipation, which holds that value is the present worth of future benefits Historical income and current income are significant, but the ultimate concern is the future."[19]

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[13] Appraisal Institute, The Appraisal of Real Estate, 15th Edition, *635*
[14] Appraisal Institute, The Appraisal of Real Estate, 15th Edition, *636*
[15] Appraisal Institute, The Appraisal of Real Estate, 15th Edition, 635
[16] The Appraisal Foundation, Uniform Standards of Professional Appraisal Practice (USPAP) 2024 Edition (The Appraisal Foundation, 2024), 21
[17] The Appraisal Foundation, Uniform Standards of Professional Appraisal Practice (USPAP) 2024 Edition (The Appraisal Foundation, 2024), 23
[18] Appraisal Institute, The Appraisal of Real Estate, 15th Edition, 33
[19] Appraisal Institute, The Appraisal of Real Estate, 15th Edition, 435